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Good Transition Needs Friendly Investment Climate—Some Lessons of Experience

By Guy Pfeffermann

Rapid growth and poverty reduction are possible only when private enterprises operate in a good investment climate. Transition governments must try to avoid the institutional vacuum that invites state capture by the parasitic elements of a society. These are some of the important conclusions of this article, which is based on the author's recent address to the Association for the Study of the Cuban Economy at Coral Gables, Florida.

Attention to institutional factors was never absent from development discussions. Indeed, the "Washington consensus," a list of policies that would promote healthy economic development, which today is unfairly greatly maligned, explicitly encompasses institutional factors. It recommends abolishing regulations that impede the entry of new firms or restrict competition, as well as putting in place a legal system that provides secure property rights and makes them available to the informal sector. To me the only unfortunate thing about the Washington consensus is its name.

What I find astonishing is how little attention the economics profession has paid to the role that private enterprises play in fomenting development.

But times are changing, and Nicholas Stern, the World Bank's chief economist, made the quality of the investment climate one of the main pillars of economic growth and poverty reduction, the other being empowerment policies, such as making clean water and health and education services available to poor people. In former communist countries, perhaps more visibly than in others, sustained economic development is impossible without a growing and dynamic private sector. None of this minimizes the role of the state. Indeed, it is hard to conceive of a good investment climate without strong and effective public management.

Doing Business...with Constraints

Doing business in developing and transition countries can be exceedingly frustrating. In 1999-2000 the World Bank conducted a worldwide survey of businesses, focusing mainly on their relations with public officials. The results will be published soon in the World Bank's Directions in Development series under the title "Voices of the Firms: Investment Climate and Governance Findings of the World Business Environment Survey," by Geeta Batra, Daniel Kaufmann, and Andrew H. W. Stone. Executives of about 10,000 firms, mostly small and medium enterprises, were interviewed in 80 countries. The firms included local firms as well as those with foreign ownership. The survey asked the executives how problematic a set of constraints for the growth and operation of their firms. The leading constraints vary by region. In Latin America, for example, the top four perceived obstacles to doing business were (1) taxes and tax regulations, (2) policy instability, (3) street crime, and (4) lack of financing. In European transition countries taxes and tax regulations also came first, followed by (2) lack of financing, (3) inflation, and (4) policy instability. Responses were similar in the former Soviet Union, except that policy instability was considered to be more problematic than inflation.

About two-thirds of firms in Central Europe, Latin America, and the former Soviet Union reported that the government was inefficient in delivering services. Worldwide, most firms expressed negative opinions about public health, parliament, and public

What's Inside

works and roads, while more than 40 percent rated the courts, the police, education services, and central government leadership negatively. The most positive ratings went to the postal, telephone, and electric power services. Executives spend an inordinate amount of their time dealing with public officials. This is obviously related to corruption, which about half the executives interviewed in the former Soviet Union and in Central Europe regarded as a serious impediment to doing business.

A good number of former communist countries have dysfunctional taxation systems. Not uncommonly, so many different taxes are on the books that honest firms would end up paying more than their total earnings in taxes. Not surprisingly, firms are driven into illegality, and hence are particularly vulnerable to demands by corrupt officials. Perhaps most important, econometric analyses of the survey results demonstrate that these institutional obstacles significantly reduce sales growth and investment. In other words, improving relations between government and business enhances firms' ability to produce what people need.

New Versus Old Enterprises

Regimes that discourage the launching of new enterprises in particular are harming economic and social development. New enterprises are more productive than old ones. They outperform old enterprises in sales, exports, investment, and employment. In the Czech Republic, Hungary, Lithuania, and Poland new enterprises have grown rapidly and now account for half or more of employment (equal to the EU average) and 55 to 65 percent of value added. Conversely, in Kazakhstan, Russia, and Ukraine, which have seen modest or no growth in new enterprises, their share of employment has stayed at or below 20 percent and their share of value added between 20 and 30 percent. The latter countries favor old, established firms, which are draining resources such as credit away from new and potentially far more productive firms (Jacques Morisset and Olivier Lumenga Neso, "Administrative Barriers to Foreign Investment in Developing Countries FIAS," Working Paper no. 2848, May 2002).

Foreign investors also face varying establishment costs in different countries. According to recent World Bank research foreign firms wishing to operate in any of the 32 countries surveyed had to undertake up to 29 administrative procedures to enter the market, up to 125 to secure a land site, and up to 26 to commence operations. The time required to secure all these permits was between 200 and 1,300 business days. As to the transition countries surveyed, permission to enter and secure land took 702 business

days in Bulgaria and 634 in Romania, but only 75 days in Slovenia, one of the more successful transition economies.

More often than not, governments that make life difficult for new enterprises are acting on behalf of powerful established firms, public or private, that have "captured" policymakers. The Worldwide Business Environment Survey suggests that in half of the transition countries firm executives report that policies, laws, and regulations have been shaped to a large extent by firms that have made corrupt payments. Firms in countries where policymakers avoided being captured, grew much more rapidly and invested significantly more than firms in countries subject to state capture. Equally important, firms that were "captors" benefited dramatically from their insider status, although not by virtue of their competitiveness.


Guy Pfeffermann

One of the most exhaustive studies of privatization and enterprise restructuring in transition countries to date (*Transition*: "The First Ten Years—Analysis and Lessons for Eastern Europe and the Former Soviet Union," Vol. 13, No. 1, 2002), useful conclusions, namely:

- Privatization to outsiders, for example, to strategic investors as opposed to incumbent state enterprise managers and workers, has a large, positive impact on enterprise restructuring.
- Hardened budgets, that is, the reduction or elimination of government subsidies to state enterprises, are also significant in explaining the extent of restructuring.
- Small firms such as restaurants and dry cleaning establishments should be privatized rapidly.

Filling the Vacuum

Just as nature abhors a vacuum, so do institutions. Once a centrally planned regime comes to an end, unless new rules of the game are introduced and swiftly enforced, an institutional vacuum will develop that is most likely to be filled by a combination of rent-seeking oligarchs tied to the new government and Mafia enforcers. Replacing these parasitic surrogates with market institutions then becomes difficult, and in some cases impossible.

Both economic and institutional reforms should be carried out quickly after transition, specifically:

- **Prices should be freed as quickly as possible**, as Poland and Vietnam did, for example. Maintaining unrealistic prices for raw materials and energy not only drained tens of billions of dollars out of Russia, but significantly discouraged enterprise creation.
- **Land and real estate ownership should be established as rapidly as possible**. Restitution claims are best dealt with by providing former owners with compensation in the form of cash or treasury bills, and not in the form of actual physical assets such as land, housing, or plant. Unless this is done, the ownership of assets may remain in doubt for years, blocking most new investment, and possibly resulting in years of lost production, capital flight, high unemployment, and social turmoil. Hungary provides a good model of how to achieve cash compensation quickly.
- **Opposition to a market economy should be minimized**. There are many ways of doing this, for example, by giving employees of privatized or reprivatized firms minority shareholdings at concessional prices and gearing social policies toward the preserving advantages that a mixed economy may not provide. For example, East Germans lost their access to free child care, and therefore women find it harder to continue working. The same holds true for access to basic services, such as clean water and health and education services, by the poor. A well-educated and healthy work force is an invaluable asset to our globalized economy, as well as to society at large.

Psyche Needs Transforming Too

As the Germans found out after the Berlin Wall came down in 1989, the psychological makeup of East Germans who grew up under socialism was quite different from that of West Germans, and in some cases remains so to this day. While some of these differences may have existed before the communist regime took over East Germany and East Berlin, mostly they resulted from 40 years of socialism. Two signal characteristics of socialization under this regime are relevant to the transition to market institutions, and they are two sides of the same coin: risk aversion and the expectation of maximum security, however dismal the standard of living.

Risk aversion translates into a bureaucratic mind-set. Employees tended to wait until they were told what to do. Party cadres tried to maintain a monopoly of initiative and organizational skills. At the same time the regime provided job security, child care, and other basic benefits, albeit often at minimal levels. Twelve years after

reunification, these attitudes still linger among older people in the eastern states of Germany, many of whom are now saying: "It wasn't so bad back then after all." Such psychological differences are hard to manage. A number of foreign businesses in Eastern European transition countries and in Russia only hired young staff who had never worked under the old regime. Demography solves the problem eventually as young people grow in numbers and eventually replace their older compatriots.

In addition to good macroeconomic policies, what is required is a firm institutional roadbed, which in turn assumes the existence of an administratively competent and relatively uncorrupt government. Most communist systems produced some good things, including the excellent education systems (by international standards) and, in many countries, good basic health services for the vast majority of the population. Good health and education, essential elements of empowerment, are invaluable assets on which postcommunist governments can build. Yet the development experiences of transition countries have been quite varied. Some, like Estonia, have managed extremely well and are on the point of joining the EU. Others have failed to bank on their human capital, partly because they did not engage in in-depth reform of their private sector institutions. Whatever the pace of transition, the process is painful and can take a good deal of time, but the alternative is worse.

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Foreign Investment Slumps in Cuba

The active local black market, the murky rules and regulations, and the negative external environment continue to discourage foreign investment in Cuba, which according to the central bank fell from $488 million in 2000 to $39 million last year. This figure is the lowest since foreign investment data were first made available in 1993. European companies in Cuba complain of an unfavorable business climate. They feel discriminated against by officials, who arbitrarily apply obscure laws and complex regulations and change agreements when it suits them. They must also cope with high overheads and frequently changing work permit requirements, among other petty annoyances. Furthermore, they often find that the state companies they have been forced to accept as partners—Cuba has 400 joint ventures—are generally unresponsive to advice and uncooperative.

Bitter Sugar

The central bank has acknowledged that Cuba is suffering from foreign exchange shortages and problems in servicing its foreign debt of almost $11 billion, of which approximately 20 percent is accounted for by overdue interest. Almost half of the total debt is to private banks and suppliers, which Cuba uses because it has no access to the multilateral financial institutions. Cuba's need for expensive short- and medium-term commercial credits is likely to increase even further, because it is buying large amounts of food from the United States. This is paid for in cash, as U.S. banks and suppliers are not permitted to finance trade with Cuba. According to the Cuban food importing agency, Alimport, Cuba will import a total of $1 billion worth of food this year, rising to about $1.4 billion in three to four years, more than half of which will probably come from the United States.

A tough sugar market and a fall in tourism present further challenges: the island's GDP growth could slow to 2 percent this year, down from 3 percent in 2001 and compared with 5.6 percent growth in 2000 and 6.2 percent in 1999. Cuban officials have revealed plans to close almost half the state-owned sugar mills: 85 of the 156 mills will go, and thousands of jobs with them, with scarce resources to be concentrated on the most modern and efficient factories. Up to 1 million hectares of land, approximately 50 percent of the total, would be converted from sugar to other agricultural uses. The industry is the country's main employer, with 400,000 workers. Officials have promised to find new jobs for those who are laid off and to pay at least 60 percent of their wages in the meantime. This is the most dramatic economic move since the decision by Fidel Castro, Cuba's president, to allow the use of dollars on the island in 1993. Officials have been urging reform of the antiquated sugar industry for years. The mills are in poor condition, and most date from before the 1959 revolution. Production peaked at 8.1 million tons in 1989, but last year stood at only 3.6 million tons.

Before the collapse of the former Soviet Union, Cuba could barter its sugar with its socialist allies at preferential rates in return for oil and other essentials. Now it must sell its sugar on the world market, where it is worth 5 cents a pound. Cuba earned just $430 million from its latest sugar harvest, down from perhaps $5 billion in 1990, and its inefficient mills guzzle oil. Since October

2000 Venezuela has been supplying a third of Cuba's oil imports, on credit and at 2 percent interest. In November it rescheduled previous payment arrears, but Cuba quickly fell into arrears again, and by April these totaled $63.4 million. Officials are now negotiating a fresh agreement, but this time Venezuela is pressing harder for payment.

In place of sugar Cuba now relies on tourism and remittances for most of its foreign exchange. But despite investment in new hotels and resorts, a slowdown in the world economy coupled with a post-September 11 downturn in travel has sent the number of visitors plummeting. In the first quarter of this year tourist arrivals were 14 percent below the same period last year. Recovery is expected later this year and in 2003, but it will be gradual.

Remittances from Cuban-Americans, worth between $500 million and $800 million in past years, have fallen sharply. Now the government intends to take a bigger slice of a smaller remittance pie. At the dollar stores gasoline is to go up from $2.85 to $3.99 per gallon, while the prices of electrical goods will go up by 30 percent. This will have a substantial knock-on effect on food prices and transport costs. Local salaries of around $10 to $15 per month cover only the barest essentials, mainly subsidized food. Many Cubans depend on money from abroad for everything else including gasoline. Peso shops are empty of goods, while essential items are increasingly being removed from ration books and sold for dollars only.

Plans for the Future

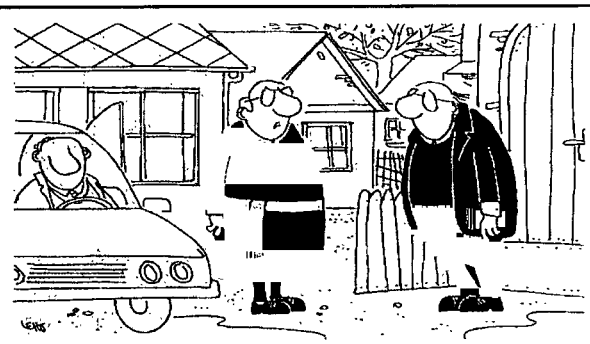
The effects of communism on the population's mentality—decades of stifling bureaucracy, incessant propaganda, and an extreme "nanny state"—have been immense. Entitlements became a way of life. No one expected to get fired, and the government was viewed as the solution to all problems. Most things—even the shortages and inefficiencies—were predictable. For the worker, peasant, or civil servant the system had considerable attractions Nobody worried about investments, college tuition, or mortgage payments, wrote Anders Aslund and John Hewko, now with the Carnegie Endowment for International Peace, in a recent article for the *Washington Times*.

The arrival of capitalism, with its plethora of choices and risks, upset that predictability and proved unnerving to most of the working class and older generation. For most in the West it was difficult to comprehend the importance of contacts, friends in high places, and well-placed relatives. Once the lid of repression was off, these forces of privilege emerged with an uncontrollable vengeance, so that freedom initially aggravated corruption and crime. An oligarchy of former communist managers thrived on the transitional chaos to amass enormous wealth. The easiest fortunes were made on privileged trading between low state-controlled prices and high market prices. The cost was borne by the older generation and pensioners, too old to adapt to the rough and tumble of the market.

Cubans must be mobilized and empowered. Preaching the principles of capitalism is not enough. Early democratic elections to a new parliament are vital to putting in place a functioning legislature that can adopt the hundreds of laws a market economy requires. A popularly elected president cannot do this alone. Early and thorough privatization is an economic necessity, but it is also a good means of giving many a share in the new market economy. Elsewhere restitution has worked well for housing and family farms, though it has not been politically acceptable for large enterprises, even in eastern Germany.

The first moment of economic reform is vital. The focus has to be on the fundamental principles: maximum liberalization and financial stabilization. When prices and markets are deregulated, inflation is bound to skyrocket, requiring firm fiscal and monetary policy. If the rulers hesitate, the social costs of transition will only rise. A new class of entrepreneurs and civil servants will have to be trained, while business investment is best left to the private sector. According to Aslund and Hewco many mistakes were made after the fall of the Berlin Wall, and we can only hope that they will not be repeated when the Castro regime collapses.

Based on reports from Oxford Analytica and the Economist Intelligence Unit as well as a recent article in the Washington Times.



Father Jazmin, maybe the Bible has no word for it, but you have to inform the episcopate if you plan a capital increase in your company.

From the Hungarian daily *Népszabadság*

Labor Policy Dilemmas Preceding EU Enlargement

As the EU enlargement is approaching, public anxiety is clearly detectable among both present and future member states. Current members worry about whether a mass influx of job seekers from Eastern Europe will endanger their jobs. Future members worry about whether the enlargement will expose their skills as obsolete and crowd them out of even the domestic job market. The following articles focus on pre-accession labor policy dilemmas as analyzed by a World Bank study and a senior economist from the Economist Intelligence Unit and as exposed by 13 prominent economists in their passionate appeal for action.

Labor Markets of the Accession Countries: Fit to Join?

By Michelle Riboud, Carolina Sánchez-Páramo, and Carlos Silva-Jáuregui

Observers often view European labor markets as rigid and inflexible when compared with those in North America, where legislation is less protective of employment and fosters greater mobility. They often attribute the high unemployment rates that persist in numerous parts of Europe to these rigidities. The debate has taken on renewed relevance with the potential entry of Central and Eastern European (CEE) countries into the EU. The authors compare labor market institutions and their impact on labor market performance in the Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia.

With the help of a set of indicators—such as the magnitude, coverage, and cost of employment protection; the effectiveness of passive and active labor market policies; the strength of trade unions; and the tax burden on labor, for example, through payroll taxes—we can rank the Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia according to the degree of flexibility of their labor market policies. [Editor's note: Given their varying perspectives, employers and employees tend to have different opinions about what an optimum labor policy might be. Most workers expect as much job security as possible without caring too much about flexibility, while employers want to have a free hand in hiring and firing. Many economists try to reconcile the two views, believing that the less employers are tied up with regulations, the more jobs will be available. Thus they regard labor market flexibility as an important condition for reducing unemployment and eventually meeting workers' aspirations.]

These indicators revealed the following:

- In terms of employment protection, Hungary seems to have adopted the most flexible legislation and Slovenia the least flexible.
- When compared with EU members and countries of the Organisation for Economic Co-operation and Development (OECD), with the exception of Slovenia, these countries tend to be in the middle of the labor market flexibility scale.
- CEE countries have adopted the set of passive and active policies common to all EU and OECD countries, but they are devoting modest amounts of budgetary resources to the unemployed.
- These countries have moved away from a centralized wage bargaining system and toward a more liberalized system of wage negotiation. The tax burden on labor in these countries is the highest in Europe.

While the objective of legislation that restricts employers' freedom to dismiss workers is to protect employees' welfare by reducing their exposure to unfair actions and their risk of fluctuating incomes, such regulations may increase the costs of employing workers. The consequence can be a smaller number of vacancies, and thus lower employment levels. In Hungary a written statement to an employee is sufficient for dismissal, while in other countries the notice of dismissal must be shared with a third party, usually an employee representative body. In Hungary and Poland unsatisfactory performance and job redundancy are sufficient reasons for dismissal, whereas in the Czech Republic, Estonia, Slovakia, and Slovenia employers are required to take social considerations into account, to look for retraining opportunities

for employees let go, or even to ensure workers' transfer to another suitable position. In both Hungary and Poland the notice period is short and the severance payment is small.

Active and Passive Labor Market Policies

While passive labor market policies to support the unemployed, that is, unemployment insurance systems, may create incentives for workers to remain unemployed for longer than they might otherwise be inclined to do, active policies, such as assistance with finding another job, training provision, employment on public works, and subsidies, aim at facilitating workers' re-entry into the labor market. The CEE countries have adopted packages of measures similar to those of other European countries, but they differ significantly in terms of benefits and program coverage and duration, as well as in terms of their relative preferences for passive or active policies.

The generosity or lack thereof of a particular unemployment insurance system depends on the quantity and duration of the benefits and the system's eligibility rules as follows:

- **Magnitude**. A simple way to compare benefit quantity across the CEE countries is to look at benefit replacement ratios, that is, the initial level of benefits divided by some average measure of previously earned income. Replacement ratios in the CEE countries range from 40 to 64 percent, except in the case of Estonia, where the ratio is a mere 10 percent (see table 1). Benefits can also be expressed as a fraction of the minimum and average wages in each country. The unemployment benefits in the six CEE countries under discussion amount to 60 to 100 percent of the minimum wage and 10 to 45 percent of the average wage.
- **Duration.** In the Czech Republic and Estonia benefits are paid for a maximum of 6 months, compared with 12 months in Hungary and Slovakia and 24 months in Poland and Slovenia. These figures are similar to those in the EU and in OECD countries (6 months in the United States, 12 months in the United Kingdom, 24 months in Spain, no limit in Belgium).
- **Coverage rates,** that is, the percentage of the unemployed receiving unemployment insurance benefits. In the Czech Republic and Estonia those rates are around 40 to 50 percent and have remained fairly stable over the last decade. This has also been the case in Hungary, although at 70 to 75 percent, coverage is much higher. In contrast, the other three countries saw coverage rates fall continuously throughout the 1990s, from 80 to 20 percent in Poland and Slovakia and from 40 to 30 percent in Slovenia.

Table 1. Unemployment Rates in 2000 and Features of the Unemployment Insurance System in Selected OECD and EU Accession Countries

Country	*Unemployment rate, 2000 (percent)*	*Benefit replacement ratio (percent)*	*Maximum benefit duration (months)*
OECD			
Australia	6.3	36	No limit
Austria	3.7	50	5–12
Belgium	6.9	57	12-no limit
Canada	6.8	59	12
Denmark	4.4	70	60
Finland	9.8	63	24
France	9.3	70	27–54
Germany	7.7	61	6–32
Ireland	4.1	49	15
Italy	10.4	42	6
Japan	4.7	60	6
Netherlands	2.8	69	6–54
New Zealand	6.0	30	No limit
Norway	3.5	67	46
Portugal	4.1	65	10–30
Spain	11.3	73	4 – 24
Sweden	5.8	75	12 – 18
Switzerland	2.0	73	8.5 – 20
United Kingdom	5.3	36	12
United States	4.0	60	6
EU average	6.3	60	n.a.
OECD average	5.9	58	n.a.
CEE			
Czech Republic	9.0	50	6
Estonia	13.8	10[a]	3-6
Hungary	6.4	64	12[b]
Poland	14.0	40	12-24[c]
Slovakia	17.8	60	6-12[d]
Slovenia	12.2	63	3-24[d]
CEE average	10.5	48 (55)[e]	

(a) Benefits are set at 60 percent of the minimum wage. This amounts to approximately 10 percent of the average wage.
(b)Requires four years of employment.
(c)Benefit duration increases with previous employment tenure.
(d)Benefit duration is a function of the worker's contributive history.
(e)Figure in parentheses does not include Estonia.
Source: World Bank data.

Such differences in benefit quantity and duration and in coverage rates translate into differences in spending on

unemployment insurance. The six CEE countries spend an average of less than 1 percent of GDP on unemployment insurance, for instance, Poland spends 1.7 percent of GDP, while Slovenia spends 0.9 percent and Estonia less than 0.1 percent These aggregate spending figures can be misleading, however, because they are partly a function of the number of unemployed The ratio of GDP spending to the unemployment rate can therefore be used as an alternative measure of expenditure This ratio is generally lower in the CEE countries than in the EU and OECD member countries, which devote more than 1 percent of GDP (0.25 percent of GDP per percentage point of unemployment) to unemployment insurance.

Table 2. Payroll Taxes

Country	*Percentage of gross wages*	*Year*
Czech Republic	47.5	2000
Estonia	33.0	2000
Hungary	48.5	2000
Poland	35.1	2000
Slovakia	50.0	2001
Slovenia	38.1	2000
CEE average	42 7	2000-01
EU average	23.5	1997-98

Source: IMF data.

Active labor market policies cover a vast array of programs, including job search assistance and counseling, training for the unemployed and for youth, employment subsidies, direct job creation, and special measures for disadvantaged groups. The EU accession countries spend between 0.08 and 0.83 of their GDP on active labor market policies. Even though these are not large amounts, important differences are apparent across the countries, for example, as a percentage of GDP, Slovenia spends 10 times more than Estonia. Adjusting this measure to account for differences in unemployment rates, the CEE countries spend between 0.01 and 0.11 percent of GDP per percentage point of unemployment on active labor market policies.

When choosing between active and passive policies, the experience of the six CEE countries is mixed Estonia, Slovakia, and Slovenia spend almost the same on both types of programs, measured as a share of GDP per percentage point of unemployment, while the other three countries favor passive policies over active ones. In so doing they are closer to the average OECD member. In practice most EU and OECD countries devote more resources to their passive labor market policies than to their active ones, the exceptions being Italy, Norway, and Sweden.

Strength of Unions and Tax Burden on Labor

In most European countries except the United Kingdom, trade unions play a significant role in wage determination, and even when the number of unionized workers is fairly low, agreements reached under collective bargaining can extend to nonunion members, thereby covering a large proportion of the labor force Furthermore, the impact that collective bargaining can have on wages is likely to depend on the degree of coordination that exists between different unions and employer associations, as well as on the extent to which the government is involved in the negotiation process. Compared with countries in the EU and the OECD, the six CEE countries fall in the middle of the range in terms of union strength and coordination regarding collective bargaining (see note on page 10).

The CEE countries present a fairly homogenous picture regarding wage bargaining and the role of unions and employer associations During the last decade these countries all started to move away from a centralized wage bargaining system and toward a more liberalized wage negotiation regime, and these changes have been especially relevant for newly created firms. As a result, even though union density and coverage are still high, important differences are apparent between the public and private sectors, with unions holding a much weaker position in the latter. Union membership ranges from 34 percent of all salaried workers in Poland to a reasonably high 62 percent in Slovakia; however, this does not translate into high union bargaining power because of low coordination among unions. In practice, although basic guidelines are sometimes established through tripartite negotiations with the government, most wage bargaining takes place at the industry or the firm level, and in the private sector employers set wages. EU and OECD members present a more varied picture

Payroll taxes are high in the six CEE countries, even by Western European standards (see table 2) Rates range from 33 percent in Estonia to 50 percent in Slovakia, while only France, Italy, Spain, and Sweden have rates above 30 percent, and in no case are rates higher than 40 percent During the transition period the fiscal pressure to maintain high payroll taxes, or even to increase them, was extremely strong. Unemployment was on the rise, which forced governments to continuously increase their spending on unemployment insurance systems and active labor market policies

Aging populations and declining employment rates also put additional strain on public pension systems through falling revenues and increased outlays. Finally, a decrease in other types of tax proceeds caused by the economic contraction obliged governments to look for alternative sources of revenues to cover public expenditures, especially for health and social assistance. Yet despite these problems some CEE countries such as Hungary have recently started to lower their payroll taxes, albeit at a slow and gradual pace, and there is reason to believe that other countries will follow as their economic situation improves, bringing unemployment down. Moreover, the tax burden on labor exceeds the amount of the payroll tax. Sales and income taxes also affect workers' incomes and are part of the tax wedge between labor costs and take home pay. When both consumption and income taxes are considered, the total tax burden on labor varies greatly between countries and CEE countries continues to have the highest total tax rates.

General Characteristics of CEE Labor Markets

The structural reform agenda had a significant impact on labor market dynamics in CEE countries. The sharp decline in total employment and the relative increase in private sector employment, the shift in economic activity and the reallocation of labor between sectors, the changes in skill mix, and the reduction in real wages that occurred during one decade would not have happened without wide-ranging structural reforms. The following are some of the major characteristics of CEE labor markets:

- **Employment levels have not recovered**. Although output started to grow in the mid-1990s and in some cases has surpassed pretransition levels (in Hungary, Poland, and Slovenia), employment levels have not followed the same trend. In other words, the correlation between employment and growth, although positive, has been weak, and employment continues to lag behind output recovery. This is a source of concern, because employment to population ratios in CEE are among the lowest when compared with those in EU and OECD countries. Research findings show that by increasing both the costs of hiring and of laying off workers, job security provisions reduce the employment to population ratio and increase unemployment. Thus the possible negative impact of regulations on total employment cannot be dismissed.
- **Long-term unemployment is high**, another feature that has been associated with stricter employment regulation. The pool of unemployed in CEE economies has remained fairly stagnant, with low worker turnover and increasing numbers of long-term unemployed. In this respect the CEE countries do resemble other European countries. In contrast, the long-term unemployed do not represent more than 7 percent of the pool of unemployed in the United States, which has by far the most flexible labor market. In sum, while no firm conclusion can be reached, low job creation and high long-term unemployment have often been associated with inflexible labor markets. Both may become a source of social tensions and impose an increasing burden on public budgets.
- **Participation rates are falling,** especially among women and older workers. The reduction in the amount of child care support provided by the state and the subsequent increase in child care prices, combined with a decline in the number of child care centers and the tightening of social assistance for mothers with small children, has led numerous women to exit the labor force to attend to their children. Similarly, the existence of support for the unemployed made it easier for employers to dismiss workers, and early retirement schemes made it more attractive for older workers to exit the labor force. In many countries such retirement schemes were used as a device to control unemployment among this particular group of workers. High exit rates among certain groups of workers therefore helped keep the unemployment rate lower than it might otherwise have been. For example, in Hungary in 1999 the labor force participation rate fell to 11 percent for women aged 55 to 64 and to 30.8 percent for men, compared with EU averages of 30.5 and 52.7 percent, respectively. Moreover, exit by choice combined with the labor market entry of large numbers of younger, more educated workers, substantially altered the overall composition of the labor force in the CEE countries.
- **Payroll taxes and the overall tax burden on labor are high** relative to EU countries. High taxes on labor presumably create incentives for self-employment and an enlargement of the informal sector. In this regard the effect of high payroll taxes may affect employment protection legislation.
- **Wage inequality is increasing,** but assessing whether it has reached levels comparable to those in other countries is difficult, that is, determining the extent to which inherited institutions and social norms still play a role in the wage determination process. Certainly changes in the bargaining system have been accompanied by a sharp increase in private sector employment and a decompression of the wage structure.

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Trade Union Strength in Six CEE Accession Countries

Czech Republic. The two main trade unions and two main employer associations operate on the basis of free association. Agreements signed between unions and employer associations are only binding for union workers and firms that belong to the employer association. In addition, if a firm disagrees with a certain industry-level agreement, it is free to leave the employer association and ignore the agreement. Labor unions are weak, with the exception of those in sectors where the presence of public enterprises is still substantial. As a consequence, union coverage is limited, with only 30 percent of the workforce covered by the 1,222 collective agreements signed in 1998, and the number of new unions in privatized and new companies is low.

Wage bargaining occurs at multiple levels. First, if the government is willing to participate in the negotiations, a tripartite body composed of representatives from trade unions, employer associations, and the Ministry of Labor and Social Affairs determines aggregate wage growth and basic working conditions. Second, industry- and firm-level negotiations take place between employers and unions; however, in practice employers determine wages except in the public sector, where negotiations must comply with a wage grid. Although initially the tripartite body was responsible for determining the minimum wage, since the mid-1990s the Ministry of Labor has unilaterally made adjustments as it considered them to be necessary.

Estonia. During the 1990s union membership declined from almost 100 percent to 30 percent. This decrease was mainly due to privatization and the increasing importance of small and foreign firms, where union presence is generally weak. In addition, the bulk of economic activity shifted from manufacturing, where traditionally unions were strong, to services. The level of coordination among employers is not high either. They are represented, on a voluntary basis only, by a single employer association that covers around 6,000 firms, or 200,000 employees out of a total of approximately 640,200. As a consequence, the government plays a major role in shaping industrial relations, which are thus based on laws rather than on agreements. Both unions and employers are invited to participate in the design of such laws through tripartite negotiations; however, discussions focus on working conditions rather than on wages. These are generally determined unilaterally by employers at the firm level, or by the government in the case of public sector workers.

Hungary. Trade unions have mainly been relegated to newly privatized state firms, as they have gained little representation in new companies. This implies that unions are strong in heavy industries and weak in the expanding service sector. General economic policy issues and labor matters are discussed in two different forums. The first is the Economic Council, a consultative body composed of representatives of different organizations, including trade unions and employer organizations, multinational investors, the Hungarian National Bank, and the government. The second forum is the National Labor Council, a tripartite council for consultation and negotiation on such labor issues as employment legislation, industrial relations and social policy, training, wages, and work place safety regulations. Although the National Labor Council is also empowered to set the minimum wage and to recommend wage increases, centralized collective bargaining has never been important in Hungary. Wage deregulation had began already before transition, and during the privatization period most private sector wages became freely negotiable at the industry and firm level. Hence some form of collective bargaining is still binding only in the public sector, which is regulated through a strict wage tariff system.

Poland. Unlike its Central European neighbors, one of the main features of Poland's labor market is the large number of labor organizations. Trade unions and other employee organizations, which started and accelerated the transition process, still play an important role. Currently the two most important trade union confederations are Solidarity and the Organization of Postcommunist Trade Unions, but there are also another 9 smaller nationwide union confederations, 273 national trade union organizations, and about 24,000 local trade unions organized by enterprise, industry, or region. Poland also has more than 1,000 employer organizations.

By law unions enjoy extensive power in the areas of workers' rights, wage policy, and social benefits. In contrast, they have no control over managerial decisions

regarding company strategy and ownership transformations. In the last few years constant growth in the number of small and medium enterprises (90 percent of all firms outside the agriculture sector have five or fewer employees and 89 percent of these are sole proprietorships) has eroded the unions' power, so that most of their current activity is concentrated in large, heavy industry firms yet to be privatized.

Since 1995 industrial relations have been organized through the Tripartite Commission, which includes representatives of the government, employers' associations, and trade unions. Other smaller, more localized organizations composed of trade unions, local government officials, employers' associations, and unemployed workers' groups serve as consultative and advisory bodies to the heads of general administrative organs. Wage negotiations between employers and workers can take place at the industry and the firm level; however, collective agreements can be adopted only when a union is present. This implies that in practice, collective agreements cover mostly state-owned or large privatized companies rather than newly created private firms. As a consequence, during the last decade average pay in the public sector has remained significantly higher than in the private sector.

Slovakia. Union coverage is fairly extensive. Moreover, unions play an important role in the design of industrial relations, as the 1997 Employment Act stipulates that they be represented as a social partner at all levels of the National Labor Office and its organs. The Confederation of Trade Unions, composed of 42 independent groups, is the largest union, while the two most important employer organizations have 27 member organizations. Slovakia adopted a tripartite system to regulate labor and industrial affairs in 1990. The Council of Economic and Social Agreement consists of 21 representatives from trade unions, employer associations, and the government. The council also determines the minimum wage and the poverty line. Further wage negotiations are conducted at the industry and firm level.

Slovenia. The 130 national trade unions operate along industrial and occupational lines. Membership in 21 of them represents at least 15 percent of all employees in that particular industry or occupation. Employers, by contrast, are organized in three different associations, and their interests are also represented by the Chamber of Commerce, membership of which is compulsory. According to current labor legislation, collective agreements are the main instrument for determining the specific rights and duties of employers and employees. Consultations occur first at the national level, resulting in a collective agreement for the private sector that establishes base wages and adjustment factors for 26 industries and 9 education levels and a collective agreement for the nonmarket sector. Both agreements constitute the basis for all other contracts, thereby limiting wage variation across industries and firms.

In addition, social dialogue is also organized around the Economic and Social Council, founded in 1994. This is a national tripartite consultative body of 15 representatives, 5 from each of its 3 members (the government, trade unions, and employers). The council provides recommendations concerning legislation, such as compulsory insurance schemes (old age and disability pensions, social welfare, allowances), employment, labor relations, collective bargaining, prices and taxes, and economic policy. Its recommendations are submitted to Parliament. The council also plays an important role in facilitating negotiations between unions and employer associations.

Early Capitalism

Well then, while I'm away on vacation, watch yourself: no coffee-breaks, no shopping and no telephone calls!

From the Hungarian daily *Népszabadság*

Creating More Jobs in Central and Eastern Europe

Analysis of the Economist Intelligence Unit

The main stumbling block in integrating East and West is not further liberalization—although a reduction in the high payroll taxes would be advisable—but faster output growth that generates higher employment, along with measures to boost labor mobility.

The EU's main economic problems are a sclerotic labor market and high unemployment. The situation in Eastern Europe is worse. Average unemployment in the 10 Central and Eastern European (CEE) countries that are candidates for EU membership was more than 12 percent in 2001, compared with 8 percent in the EU.

The Shadow of Unemployment

In some candidate countries such as Poland and Slovakia, one-fifth of the labor force is out of work. Long-term unemployment is a serious problem, with two-thirds of all unemployed having been out of work for more than a year in some countries. Young people and unskilled workers suffer disproportionately. More than one-quarter of young people are looking for jobs in the CEE countries, compared with an average of 16 percent in the EU. Again Poland and Slovakia are particularly badly affected, with 35 to 40 percent of all those under 25 years old out of work.

Millions of jobs were lost in the early 1990s, when output collapsed after the onset of economic transition. However, faced with bleak re-employment prospects, many laid-off workers did not join the unemployment queues, but left the labor force altogether. Older workers took early retirement, women stayed at home, and others moved into the shadow economy. As a result the participation rate—the share of working-age people that either have a job or are actively seeking one—fell in all the countries. Had that not been the case, Poland's unemployment rate might now be more than 25 percent and Hungary's could be approaching 15 percent.

While economic growth picked up almost everywhere in the second half of the decade, employment remained stagnant, or even continued to fall. In Hungary, Poland, and Slovakia only 55 to 56 percent of the working-age population is employed. The real difference between the EU's and the CEE countries' labor markets is therefore not unemployment rates, but employment trends. The average employment rate (the number of employed as a share of the working-age population) in the EU stands at 65 percent, still well below the 72 percent in the United States, but at least the rate is rising steadily. The EU has set itself the ambitious target of raising employment rates to 70 percent by 2010 under its Lisbon development program. By that time all the CEE countries will probably have joined the EU; however, if current trends persist or do not change significantly, the new members (as well as some of the old members) will still be a long way from the EU's employment targets.

How Effective Is the EU's Medicine?

Although labor market policies are left largely to the individual member states, the EU has drawn up numerous programs to support job creation and improve the functioning of labor markets. Observers generally see the EU's labor market woes as a consequence of institutional rigidities, distorted incentives, and a dearth of professional and technical skills. The EU plans to improve the situation through a mix of deregulation, active labor market policies, and training, and is now advising the applicant countries to follow suit.

The prescribed medicine may have little relevance for Eastern Europe, however, as the latter's labor markets are, on average and in most aspects, already more liberal than those in the EU. Employment protection rules in the CEE countries are relatively lax and are poorly enforced, especially in the small and medium enterprise (SME) sector. Trade unions play a subordinate role in wage bargaining, and low unemployment benefits do not deter the unemployed from seeking work. On average, the CEE countries clearly have more flexible labor markets than many current EU members.

Restrictive rules on dismissals, mass layoffs, and part-time and temporary work raise the costs of employing workers and may increase unemployment. On average, employment protection legislation in Eastern Europe is formally at least as strict as in the EU, although the

rules are less likely to be observed than in most EU countries other than in some of the Mediterranean members. Significant differences are also apparent among the CEE countries. Employment protection legislation in the most liberal accession countries such as Hungary is less flexible than in the EU front-runners (Ireland and the United Kingdom), but more so than in France, Germany, and Italy. Only in Slovenia are labor laws as rigid as in the EU's Mediterranean members.

Laying off workers is relatively easy in Hungary, but can be a drawn out and complicated affair in other accession countries. In Slovakia and Slovenia, for example, notice periods are lengthy and severance packages may amount to five months' pay. Employers may also be required to provide retraining or help with finding alternative employment. Downsizing can be challenging in countries such as Bulgaria, where mass layoffs require complicated agreements with trade unions. Hungary allows almost unlimited use of temporary contracts, as does the Czech Republic. In Poland, by contrast, the use of fixed term contracts is severely restricted, although the government is now trying to loosen these constraints.

Blaming the Unions

Powerful labor unions have often been blamed for the EU's inflexible wages and rigid work conditions and have been the main opponents of the kind of labor market deregulation that the EU is now prescribing for its member states. Although union membership is high in many CEE countries, this does not mean that the unions necessarily have much influence. In Hungary, for example, almost two-thirds of all salaried workers are trade union members, but the unions are weak and fragmented, so their influence hardly ever extends beyond their factories. This allows flexibility in adjusting wages in line with regional and sectoral conditions. In Germany, by contrast, less than 30 percent of the workforce is unionized, but the unions are immensely powerful because of Germany's highly centralized bargaining system, which sets industrywide wages and working conditions.

In Poland labor unions have traditionally enjoyed considerable economic and political clout, but recently their position has been greatly diminished. In Poland, as in most other CEE countries, labor unions have an appreciable influence in the public sector and in extremely large privatized enterprises, but much less of an influence in the bulk of the private sector, where the trend is toward decentralized wage bargaining.

Most European countries have set minimum wage levels to prevent the emergence of a class of working poor; however, high minimum wage levels can price low-skilled and young workers out of the labor market and discourage job creation. In Eastern Europe minimum wage levels are generally low, but they matter more than in Western Europe, because many payments such as public sector wages and social benefits are calculated as multiples of the minimum wage.

In the Czech Republic and Hungary minimum wages amount to only 20 percent of the average wage. Even Poland, where the ratio is 40 percent, compares favorably with countries such as France and Germany, where the ratio is around 50 percent. However, the much larger disparities in wage levels mean that Poland's unified minimum wage has become a problem in some segments of the labor market. In Warsaw the national minimum wage is low enough not to deter the unemployed from seeking jobs, but the wages of unskilled workers in Poland's most depressed regions hover just above the minimum wage. The government is now thinking about differentiating minimum wages by region and skill levels, but this proposal has encountered considerable trade union opposition.

In some EU countries generous unemployment benefits reduce the incentives of the unemployed to look for work, especially at the low-paying end of the labor market. Unemployment insurance systems in the CEE countries offer lower benefits and limit the duration of entitlement more rigorously. In the Czech Republic and Poland, for example, the unemployed can expect to receive benefits amounting to 40 to 50 percent of their last salary, compared with 60 to 75 percent in France, Germany, and Spain. Poland offers unemployment benefits for up to two years, whereas the Czech Republic cuts them off after six months. Hungary is in the middle, offering relatively generous benefits for up to one year.

Nevertheless, far fewer people are drawing unemployment benefits in Eastern Europe than one would expect from the high unemployment rates (as calculated from labor market surveys, rather than based on claimant counts). In Hungary 70 percent of all those unemployed receive benefits, but this share falls to 50 percent in the Czech Republic and 20 percent in Poland and Slovakia. As a result the CEE countries spend only 0.7 percent of their GDP on unemployment insurance, less than half the EU average.

High taxes on labor are the main institutional problem for Eastern Europe's labor markets. In Slovakia payroll

taxes add a staggering 50 percent to employers' labor costs. Hungary is not far behind, and Poland, at 35 percent, is at the lower end of the regional range, with the average standing at around 43 percent. In the EU only the Mediterranean countries have payroll taxes above 30 percent. The total tax burden on Eastern European labor is even higher than these figures suggest. Once income and indirect taxes are added, the difference between labor costs and take-home pay rises to more than 80 percent in Hungary and Slovakia, compared with a typical 40 to 50 percent in the EU.

High taxes on labor discourage job creation, drive businesses into the shadow economy, and encourage self-employment. This means that Eastern Europe may be stuck in a vicious circle. Rising unemployment has become a growing burden on public finances as employment—and thus the tax base—has shrunk at the same time, and therefore the tax burden on those that still have work has risen relentlessly. This in turn has added to both workers' and employers' incentives to avoid taxes either by underdeclaring wages or by moving into the shadow economy. Reducing high payroll taxes is a priority if the CEE countries want to increase employment levels; however, as state budgets are already strained, this will require more thorough reforms of social security systems, which can only be implemented over the medium to long term.

Despite the differences between the EU and the applicants, the candidates seem to be trying to mimic the kind of labor market institutions prevalent in the EU. Although the CEE countries spend much less on labor market policies than the West—on average less than 1 percent of GDP compared with 3 percent in the EU—the general trend is upward. However, the applicants cannot afford the West's generous social security schemes.

More Jobs Are Needed

What Eastern Europe needs first and foremost is more jobs. Traditional industries such as steel and energy are still in the process of restructuring, which implies that labor shedding will continue, but the new private sector is not creating enough new jobs to soak up laid-off workers. Since the end of the transition recession in most countries in the mid-1990s, real GDP growth has been accompanied by low or no employment growth. High labor productivity growth has boosted wages and private consumption, but this also implies that the CEE countries will have to grow much faster in the future to raise their employment levels.

Medium-term growth rates are unlikely to pick up appreciably in most CEE countries, compared with the rates seen during the second half of the 1990s, and may not be sufficient to support net job creation. Alternatively, the quality of growth may have to change so that more jobs are created at the same rates of output growth. Governments in the CEE countries are hoping that expansion of the SME sector and continued foreign direct investment (FDI) will promote future job growth; however, neither has a clear-cut strong impact on employment.

FDI has created hundreds of thousands of relatively well-paid jobs across the region in sectors ranging from automotive to retail, but it may also have destroyed as many. Foreign acquisitions of local enterprises tend to be followed by rigorous downsizing and productivity-enhancing investment. Subsequent growth creates new employment, but in some cases this replaces existing jobs elsewhere as foreign-owned companies expand their market shares at the expense of local competitors. Also local suppliers have often been replaced by imported components as foreign investors have incorporated their acquisitions into global manufacturing networks. The World Bank found that FDI had a net positive impact on job creation in Poland, but a negative one in Lithuania and Slovakia. In Poland this may have been because of the job guarantee clauses that some countries have routinely written into their privatization contracts. These, however, only offer temporary protection. The rapid rise in Polish unemployment since 1998 has been partly linked to the expiry of such job guarantees.

SMEs have been the main engine of job creation in most CEE countries since the early 1990s. In Poland, for example, the share of employment provided by SMEs grew from 15 percent in 1993 to more than 60 percent in 1998, although it has been somewhat stagnant since. Although SMEs have been a useful employment buffer over the last 10 years, their potential for future employment growth may be limited. Among those SMEs that survive only a minority ever grows beyond one employee, usually the owner.

The Regional Divide

The main problem is that both FDI and small enterprises tend to cluster around rapidly growing urban areas, where labor markets are already tight, whereas unemployment is still growing in rural areas and declining industrial regions. As a result most CEE countries have extreme regional variations in unemployment. Eastern Slovakia, for example, suffers from unemployment rates of up 40 percent, whereas Bratislava, the capital, has less than

5 percent unemployment. As discussed earlier, this is also reflected in large variations in wage levels.

Most job creation now takes place in the service sector, which still employs less than 30 percent of all workers in the CEE countries, compared with 43 percent in the EU. The service sector, however, needs professional skills and flexibility, both of which are in short supply among laid-off industrial workers. The region's underfunded education systems cannot cope. Although basic education levels are high, professional education and vocational training are underdeveloped, and the share of employees with higher education degrees is still lower than in most EU countries. The World Bank estimates that skill mismatches are at the heart of up to 30 percent of unemployment in Eastern Europe.

In urban areas and industrial growth centers, flexible and dynamic labor markets are characterized by low unemployment, high job turnover, rising productivity, and real wage growth. Although education and skill levels tend to be much higher than in low-growth regions, employers in urban areas are finding it increasingly difficult to locate well-qualified staff at a reasonable price. This contrasts sharply with the stagnant labor markets that characterize rural areas and the old industrial heartlands, which have seen the steepest collapse in output. Here unemployment is regularly in the double digits, with most workers having been out of a job for several years. Skill levels are much lower than in urban areas and are further eroded by the prevalence of long-term unemployment. The young and better educated move away if they can, leaving behind the elderly, the unskilled, and the unmotivated. The low quality of the labor force is one of the reasons why attracting foreign and domestic investors to rural and declining areas is so difficult.

Despite these regional disparities labor mobility is low, lower even than in the EU. One of the main reasons for this is a lack of infrastructure, in particular, an underdeveloped housing market. Most CEE countries were quick to privatize residential property, but housing prices have since followed regional economic fortunes, falling in some areas while increasing strongly in others. Many people are stuck with low-priced apartments in depressed regions. As mortgage systems are underdeveloped and subsidized housing is in short supply, they are in no position to move to the much more expensive urban centers. Commuting may be an interim solution for some, although infrastructure is again a problem and rising transport prices are an additional deterrent. What is needed, therefore, are better transport and housing infrastructure to bring workers to where the jobs are and programs to lure investors to depressed regions. Increased regional subsidies from Brussels could help once the CEE countries have joined the EU.

This article is a shortened version of the Economist Intelligence Unit's June 2002 Country Forecast, Regional Overview—Economics in Transition: Eastern Europe and the Former Soviet Union.

World Bank/IMF Agenda

In Fiscal Year 2002 World Bank Lending to the ECA Region Reached $5.5 Billion

In the fiscal year (FY), that ended on June 30, 2002, the World Bank committed a record $5.5 billion for 52 projects in the countries of Europe and Central Asia (ECA). With a $3.55 billion commitment to Turkey representing almost two-thirds of the total, Turkey became the Bank's biggest borrower in FY02 (figure 1). The $5.5 billion total compares with $2.7 billion in FY01 and $3 billion in FY00. Finance, agriculture, and social protection were the top sectors in terms of lending (table 1). In FY02, IBRD and IDA disbursements totaled $2.2 billion, down from $2.7 billion in FY01. Since 1991 the Bank has committed $49.2 billion to borrowers in the ECA region.

Table 1. IBRD/IDA Lending for the ECA Region by Sector, FY02

Sector	*$ millions*
Finance	2,642
Agriculture	717
Social protection	698
Law and public administration	639
Multisectoral	342
Mining	100
Private sector development	85
Water supply and sanitation	72
Electric power and energy	57
Transportation	54
Industry	45
Education	35
Environment	26
Economic policy	6
Health, nutrition, and population	3
Urban development	2

Continued on page 27

EU Labor Policies Need Urgent Reform—Prominent European Economists Warn of Enlargement's Consequences

By Tito Boeri, Guiseppe Bertola, Herbert Brücker, Fabrizio Coricelli, Juan Dolado, John Fitzgerald, Angel de la Fuente, Pietro Garibaldi, Gordon Hanson, Juan Jimeno, Richard Portes, Gilles Saint-Paul, and Antonio Spilimbergo

Recently 13 prominent European economists published a joint paper that urges policies for coping with the impact of enlargement on labor markets and social conditions in current EU member countries. They expect significant changes in the demand for labor and in industrial location and migration patterns, and consider how to promote adjustment to these shocks. The ultimate goal is a pan-European social safety net. Treating the new EU citizens differently would backfire they warn. While accepting a temporary delay before lifting all restrictions on migration from East to West, the economists call on current EU members to start opening up their labor markets to migration from the CEE countries even during this transitional period.

The initial enthusiasm about the "return to Europe" of the former members of the Soviet bloc has turned to anxiety about its potential consequences. Many citizens of the current EU members—the EU-15—are concerned that the accession of 10 CEE countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia), countries with much lower per capita income levels than those of the current members, will have a range of adverse effects. They fear mass migration, pressures on welfare systems, industrial relocation to the new EU members in response to lower labor costs, and job losses for the unskilled when displaced by more skilled migrants from the East. According to the Eurobarometer survey, an opinion poll conducted on behalf of the European Commission at least twice a year among all EU members, roughly 40 percent of the population of the EU-15 would currently vote an overwhelming no to the Eastern enlargement.

The Curse of Rigidity

The Eastern enlargement will call for significantly faster rates of interindustry labor reallocation in current EU members, but past evidence indicates that it would be hard for their labor markets' institutional configurations to accommodate this. In Germany, for example, apprenticeship-based training and industry-level wage bargaining have historically resulted not only in high productivity at the industry level, but also in remarkably low rates of worker mobility across employers, and especially across industries and occupations. Indeed, Europeans generally tend not to change jobs frequently: on average, in 2000 only 16.4 percent of the working population had been with their employers for less than one year, compared with around 30 percent for the United States .

Many EU labor markets also appear ill-suited to coping with the geographical relocation of existing industries. Regional labor mobility is much lower in Europe than in the United States. According to the European Community Household Panel, which surveys a large sample of households representative of each EU member and asks the same questions about education, jobs, families, and incomes, 1 out of 200 EU citizens (0.5 percent of the total) change residence every year. In contrast, in the United States around 6.7 million people (2.5 percent of the population) move across state boundaries every year. Even though U.S. states are more numerous and, on average, smaller than EU members, the difference in mobility rates is striking.

This difference is not solely a reflection of cultural and language differences, after all, in the 1950s and 1960s workers did move more around Europe, both within countries toward cities and industrial areas and across borders. Rather, the relative immobility of Europeans reflects the same institutions that underlie slow interindustry mobility. Continental European systems of industrial relations and social policy tend to maintain employment in declining areas and fail to reward mobility with the wage differentials and easy job finding opportunities that motivate Americans to migrate toward booming regions. In the EU linguistic differences are also complicating cross-country labor flows, and the 11 languages used at

present will increase to 21 following full Eastern enlargement. Furthermore, the lack of institutional coordination across EU members puts a de facto tax on labor flows. For example, different national regulations on supplementary pensions and the absence of harmonized taxation rules for retirement savings can significantly reduce the pension wealth of workers moving between EU members. Health care systems also vary widely among countries and those joining a new system may incur extra costs.

The growing proportion of non-EU citizens resident in the EU seems to be more mobile than the rest of the workforce. About 12 out of 200 non-EU citizens of working age change residence inside the EU every year, compared with 1 out of 200 EU natives, according to a recent survey by the European Community Household Panel. The presence of more immigrants will help the EU have a more mobile labor force, thus EU governments should not restrict this mobility through excessive regulations on employment protection, which raise the cost to firms of dismissing workers, or by maintaining the current obstacles to intra-EU migration. They should take advantage of the opportunities for efficiency-enhancing trade and migration arising from the Eastern enlargement.

Direction of Reform

EU labor market institutions should be reformed. To shelter workers from labor market shocks when competitive pressures are strong and significant structural adjustments are essential, relying more on unemployment insurance and in-work benefits and less on employment protection legislation is preferable. Unemployment insurance can cover a larger segment of the labor force not only those who already have a permanent contract than employment protection, while involving fewer efficiency losses. Temporary unemployment insurance can to some extent reconcile worker protection and mobility by providing financial incentives to find work, especially when job search efforts are appropriately monitored. Similarly, search assistance, as well as a framework of subsidized training or lifelong learning, can allow governments to cope with reallocation demands without burdening workers with an unfair share of the costs of transition.

Labor market reforms should proceed in step with appropriate deregulation of product and capital markets. Improving workers' access to financial and insurance markets is essential to make labor market deregulation politically acceptable, but wage flexibility and benefit reduction are vital for a more dynamic labor market configuration that may properly support the full integration of an enlarged EU.

Some of these mobility-friendly reforms will require concerted action at the EU level. In particular, supranational authorities should remove the remaining legal, administrative, and fiscal barriers to the portability of supplementary pension rights across EU members and properly enforce the employment principle in providing social security to immigrants. This principle means that individuals can have access to the social security system of the country to which they relocate as long as they have had a job, with entitlements to social security based on the length of their contribution records.

Invasion from the East?

The latest negotiations between the European Commission and the CEE countries on migration suggest that the Eastern enlargement will involve the free movement of labor only after a transitional period lasting up to seven years. Hence if the first candidates join in 2005, citizens of the new members will only be free to move and work in the current EU in 2012. The idea of a transitional period is dictated by politics. The European Commission has to take account of the concerns of the many EU citizens who believe that enlargement will lead to mass migration from the East that will create labor market tensions, social cohesion problems, and associated high crime rates, plus 2002 is an election year for several EU members.

At present about 300,000 nationals from the 10 CEE countries work in the EU-15, corresponding to 0.2 percent of the workforce in the EU-15. Migration from the CEE countries is concentrated in the neighboring countries and regions: around 66 percent reside in Germany and 14 percent in Austria, and the proportions of the workforce that they constitute are, respectively, 0.5 percent and 1.1 percent.

These small figures reflect tight restrictions on migration into the EU-15. Since 1990 several studies have tried to assess the migration potential associated with the Eastern enlargement. Most studies converge in predicting the long-term migration potential at about 3 percent of the current population of the 10 CEE countries, or about 3 million to 4.5 million individuals. They envisage annual flows of around 300,000 people a year, two-thirds of whom would go to Germany, falling to 150,000 within a decade of accession. At 0.8 percent and 1.2 percent of the EU's population and labor force, respectively, these proportions are not huge, yet they are substantially more than the immigration that followed the EU's Southern enlargement. The reduced labor mobility then was due in part to relatively small income differentials; increased unemployment

benefits; and flows of public capital to develop basic education, health, and transport infrastructure in the poorest regions of Greece, Portugal, and Spain.

The CEE countries are substantially poorer than the EU average (at most 35 percent of the EU's purchasing power parity-adjusted GDP per capita and 12 percent in nominal terms, see the figure on page 19), and in 41 of the 53 regions of the CEE countries, per capita income is significantly below the EU average. In addition to the average low level, the dispersion of per capita income in different regions of the CEE countries is striking. In 1998 per capita income levels in Prague were 115 percent of the EU average, while per capita income in most regions in Bulgaria and Romania was less than 30 percent of the EU average. Moreover, even in some regions of Poland, in 1998 per capita GDP was 26 percent of the EU average.

While for current EU members importing unskilled labor and exporting capital will improve economic efficiency, such outcomes are unlikely to be palatable to their citizens. According to a recent Eurobarometer survey, most Europeans favor zero immigration and are worried about the possibility of migrants abusing the welfare state. Certainly in Austria, Belgium, Denmark, Finland, France, and the Netherlands non-EU citizens are over-represented in the pool of unemployment benefit recipients, even after controlling for personal characteristics, for example, when comparisons are made with reference to low-skilled workers with the same number of dependent children. The 2001 Eurobarometer survey further indicates that opposition to Eastern enlargement is concentrated among the unemployed, those with lower levels of education, and the elderly, while ideological factors play a much less important role.

The implication is that the EU-15 cannot allow the CEE countries to implement beggar-my-neighbor policies, but at the same time they cannot impose high welfare standards on them and demand that they bear all the costs. This would slow their convergence to the EU average and reduce their economic efficiency at a time when productivity growth was vital. The imposition of high taxes to pay for a more generous social safety net may also backfire by simply expanding the already large informal sectors in the CEE countries. Thus current EU members, while making accession conditional on the existence of a decent social safety net, should contribute to the costs via structural funds. Accession can be made conditional on progress by appropriate interpretation of the Social Charter. In the new wave of accessions, part of the structural funds can be targeted at building an appropriate level of social infrastructure.

Pan-European Social Safety Net?

Another, far more ambitious, approach to the reform of social security is not even on the distant horizon of European policy discussion: establishing a pan-European safety net, a European minimum guaranteed income scheme. This social safety net would be one of the pillar institutions of the EU in the same fashion as the single market and the Common Agricultural Policy. In the single market a country that lowers its welfare standards exerts an externality on other countries by exporting its potential welfare recipients. Similarly, a country that reduces taxes on mobile factors of production exerts an externality on other countries by poaching their tax base. The greater the mobility of factors across borders, the more severe these effects. Taking account of externalities should not mean a one-size-fits-all pan-European social welfare system.

A preferable option would be to have explicit minimal standards set at the European level, with individual EU members free to improve on them, corresponding to what the least generous countries would be willing to offer if they were forced to take account of the externalities. Alternatively, the minimal standards could be determined on ethical grounds by setting them equal to the market value, at local prices, of a basket of goods considered necessary for basic human dignity. This would not prevent benefits from being too low relative to the optimum, but at least it would prevent any race to the bottom from going too far.

From a financial perspective, the EU's budget is sufficient to fund minimum social welfare programs harmonized across the EU, and the unavoidable interjurisdictional redistribution involved in providing a pan-European safety net in the presence of sizable income differences could be cofinanced at the EU level. The size of the relevant budget line would be significantly smaller than existing programs like the structural funds and the Common Agricultural Policy. No institutional reform would be required to run such a program. Even EU institutions with few supranational powers could be in charge of running income support of last resort schemes. Above the minimum level, there would be competition among national systems. The rights accumulated in the various countries would be fully portable, and workers would have pro rated access to the welfare system of the country to which they moved. This would allow EU citizens to choose the system they prefer.

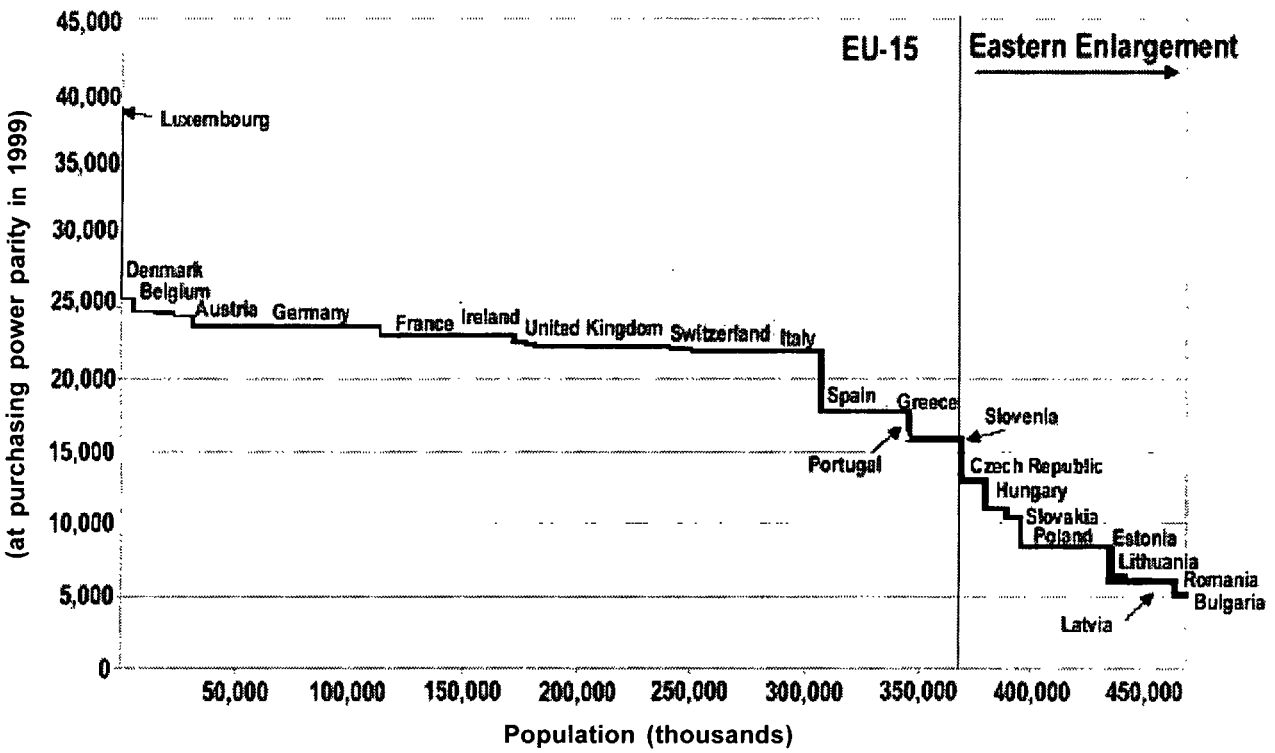
Proposals

To sum up, we recommend the following:

- Setting up more mobility-friendly labor market institutions in current EU member countries, that is, more unemployment insurance of short duration and less employment protection legislation.
- Encouraging candidate members to raise their social welfare standards, both by making this a condition of accession and by offering financial assistance for designing and starting up systems. Accession countries should have minimum guaranteed income schemes similar to those in place in most current EU members.
- Coordinating the level of these minimum guaranteed income schemes, which would be adjusted to take account of differences in the cost of living across countries and regions. The long-term plan should be to build up a pan-European social safety net as one of the pillar institutions of the EU.
- Introducing a transitional period before migration restrictions on new members are lifted, provided the period is clearly defined from the outset, restrictions are flexibly coordinated at the EU level, and existing restrictions on labor mobility within the current EU—notably those preventing the cross-country portability of social security rights—are dismantled.

This article is based on the paper "Who Is Afraid of the Big Enlargement? Economic and Social Implications of the European Union's Prospective Eastern Expansion," published by the Centre for Economic Policy Research (CEPR), London, as policy paper no. 7 in June 2002 in cooperation with Fondazione Rodolfo Debenedetti, Milan. *Tito Boeri is with the IGIER, Bocconi University in Milan, the Rodolfo Debenedetti Foundation, and the CEPR; Guiseppe Bertola is with the European University Institute in Florence and the CEPR; Herbert Brücker is with the Deutsches Institut für Wirtschaftsforschung in Berlin and IZA; Fabrizio Coricelli is with the University of Siena and the CEPR; Juan Dolado is with the University of Carlos III of Madrid and the CEPR; John Fitzgerald is with the Economic and Social Research Institute; Angel de la Fuente is with the Autonomous University of Barcelona; Pietro Garibaldi is with Bocconi University in Milan and the CEPR; Gordon Hanson is with the University of California in San Diego; Juan Jimeno is with the Foundation for Applied Economic Studies and the CEPR; Richard Portes is with the London Business School and the CEPR; Gilles Saint-Paul is with the University of Social Sciences of Toulouse and the CEPR; and Antonio Spilimbergo is with the International Monetary Fund.*

National Income Per Capita in the EU-15 and Accession Countries, 1991



Source: the authors.

Ireland's Crucial Voting on Nice—Opponents Play the Immigration Card

By Dan O'Brien

Ireland's coalition government—returned to power as a result of the May parliamentary election—knows that it needs all its energies to ensure a majority of yes votes on the Nice treaty when it comes to the second referendum, which will probably be held in late October.

The most recent opinion poll, taken in May, showed that support for Nice had sunk to a record low. Ireland's government and others across Europe were aghast in June 2001 when, on a turnout of just 30 percent, Irish voters narrowly rejected the EU's latest changes to its founding charter. The Nice treaty, the latest changes to the EU's proto-constitution, which was framed to make decisionmaking easier and to streamline the Union's institutions with a view to accommodating up to 10 new members as early as 2004. The acrimoniously negotiated Nice treaty requires ratification by each of the 15 existing member states before entering into force.

Why No?

Why did Ireland reject the Nice treaty? One in six Irish jobs depends directly or indirectly on foreign firms. Another no vote would be interpreted abroad as a move away from Europe. It would also cause uncertainty. More uncertainty means less investment, and less investment today means fewer jobs tomorrow. Thus a no vote would greatly reduce Ireland's influence in the EU. Despite being among the most enthusiastic supporters of the EU (9 out of 10 voters believe that Ireland has benefited from EU membership) the Irish shocked their fellow Europeans by rejecting the treaty in 2001.

The answer to the seemingly simple question of why the Irish voted no is almost as complicated as the Nice treaty itself, and the complexity factor was one of the major reasons why so many voters were put off during the last campaign. A brief perusal of the treaty can easily reinforce these views. The reweighting of votes at the Council of Ministers, more Qualified Majority Voting, and reform of the Commission are necessary for the EU to enlarge and still function smoothly, but they leave the average voter cold and offer few obvious incentives to vote in favor of the treaty, even for those who are generally well disposed toward the EU.

Another reason why some voted no and most of the rest did not vote at all was a lackluster and unconvincing campaign by advocates that contrasted with the energetic and ultimately effective campaign run by their opponents. Abstention and opposition to the treaty also increased in tandem with concerns about the very nature of the EU, such as who calls the shots and where the ever-evolving enterprise is going.

Scare Campaign

Immigration looks like being a central theme of the second campaign. During the first campaign, Nice opponents tried to alarm the public by claiming that the treaty would endanger the country's neutral status. Although Nice has nothing to do with it, the government secured a declaration from other EU member states at the leaders' June summit in Seville stating that Nice would not affect Ireland's neutrality. Thus some Nice opponents have switched to raising the specter of a human tide from the east. They say that because Ireland, along with Denmark, the Netherlands, and Sweden, has chosen not to make use of a transition period of up to seven years that would limit the movement of workers from new member countries, 75 million Eastern Europeans could make a dash for the only English-speaking country to offer unimpeded access to its labor market.

"Wrong," wail the Europhiles, pointing to the heaps of evidence about Europeans' immobility. But any talk of hordes from the east causes some otherwise disinterested ears to prick up. Although opposition to enlargement is the second lowest in the EU-15 and the Irish gave short shrift to anti-immigration candidates during the country's recent general election, 17 percent of those asked in 2001 said that they do not want new EU members. Their ranks are likely to swell now that the immigration card has been played.

Although an overwhelming majority believes that membership has, up to now, been beneficial, the EU is seen as elitist. A sense of exclusivity is reinforced by the coalition of insiders who support Nice, including trade union bosses, captains of industry, religious leaders, and all

but a handful of parliamentarians. Add to this the EU's image problem. It has the feel of a stuffy gentleman's club. Little wonder that the last time around women and young people were among the most likely to have rejected Nice. Perhaps because of Ireland's colonial past, there remains an acute sensitivity to any appearance of being pushed around by those in distant capitals. In recent years criticisms of "faceless Eurocrats" and of "diktats" being foisted on the country from far-off Brussels have increased.

The yes camp will depend on citizens' groups springing up to broaden its support base. Although individuals' instincts about the EU will arguably be the most important factor, basic information will also count. Most abstainers in June 2001 cited uncertainty about the issues as their reason for not voting. This has led the pro-Nice camp to believe that once the treaty has been fully explained, voters will turn out to nod Nice through. But many voters are not interested: five out of six citizens surveyed admitted to having no interest in "discussing Europe." This "disinterest ratio" is the highest among all 15 member countries.

But even if voters do take the time to read the treaty, only the lawyers among them will make much sense of such a technical and impenetrable document. This makes debate even more difficult, as the treaty does not lend itself to easy reference that would allow voters to check the veracity of competing claims. The result is that uncertainty abounds, even about the very purpose of the treaty, with the yes side saying it is all about enlargement and the no side saying it is not needed to admit new members.

The government also has some economic woes to worry about. Despite assurances of fiscal equilibrium only a few months ago during the election campaign, the truth about rapidly deteriorating public finances is out and voters are angry. Belt-tightening measures are being introduced. Almost a quarter of a million public service workers—nearly 10 percent of the electorate—are dissatisfied that their pay demands are not being met.

Enlargement Is On, No Matter What

With electoral politics losing its appeal—the 63 percent turnout in the May general election was the lowest ever—and constitutional referendums exciting even less interest (in March only 43 percent of the population voted on the emotive issue of how abortion should be regulated), it will be a wonder if much more than the 34 percent who voted in June turns out come October. Quite possibly, even though a majority is in favor of the treaty, the far more motivated minority who oppose the treaty will turn out to vote in greater numbers.

Although greater uncertainty will be introduced into the enlargement process, as long as member states do not use the rejection as an excuse to delay expansion indefinitely (a possibility that cannot be entirely discounted), the Economist Intelligence Unit believes that a wave of accession will still go ahead in 2005. The most likely way around an Irish rejection will be to incorporate those elements of the Nice treaty that are essential for enlargement into the accession treaties of the new member states. If a referendum is required in Ireland (and whether it would be is by no means certain), the straight question on enlargement should be accepted.

The author is senior Europe editor of the Economist Intelligence Unit. This article is based on his report "Ireland Will Vote No to Nice." For more information contact Jane Gardiner, Press Officer, Economist Intelligence Unit, 15 Regent Street, London SW1Y 4LR; tel.: 44-20-7830-1155, fax: 44-20-7839–1465.

After Auditing

This time the general manager is not in Florida but in detention.

From the Hungarian daily *Népszabadság*

Russian Accountancy Adopts International Standards

By Adolf J. H. Enthoven

Radical changes have taken place in the structure and process of accounting and auditing in Russia during the last 10 years, especially during the last 3 years. Russia expects to have its accounting and auditing standards in conformity with International Accounting Standards (IAS) by 2005, the EU's deadline for adherence to IAS by public companies.

The former Soviet Union used accounting as a tool to safeguard socialist property and to fulfill the state's central plans. The reporting of the financial outcomes of business activities to the central statistical office and to Gosplan, the central planning agency, was strictly controlled and monitored. Control activities included monitoring the care and retention of assets, the use of factors of production, the compliance with norms pertaining to the amount and composition of current assets, and the production of goods and services, as well as ascertaining the costs of production, the extent of financial profits, and the uses to which profits were put (see *Transition,* "The Russian Revolution in Accounting and Auditing," January/February 1999, p. 22).

Russian accountants have been collecting an immense amount of information about their companies since Soviet times, but they did not use these data to undertake comprehensive analyses or to help guide effective decisionmaking, neither did they make the results accessible to outsiders. Today Russian companies still often manipulate financial data to strengthen their position when negotiating with state authorities, whether the company is looking to pay fewer taxes or is seeking more subsidies. Outsiders find that obtaining reliable information about Russian companies is difficult, and available information about many Russian companies fails to give a clear picture of the company.

As a result, Russian accounting standards have become the usual basis of financial analysis, but these standards have considerable shortcomings and lag behind market needs. Profits as determined according to Russian accounting standards tend to deviate substantially from profits calculated according to IAS. Such statements are not useful for purposes of international comparisons or effective decisionmaking and can easily be misinterpreted.

Traditionally, Russian accounting methodology has been oriented toward financial accounting. Internal operational management systems have consisted of a collection of different methods quite independent of each other. Management accounting—which analyzes basic financial information, develops financial forecasts, and guides budget preparation—has not existed in the form known by Western accountants, although enterprise administrators do make extensive use of cost accounting and cost analysis. Activity-based costing (assigning and managing costs based on activities) barely exists, and the absence of true pricing often makes cost estimates useless.

In 1991 three events occurred that were crucial to the development of accounting in Russia, namely:

- Publication of the mostly new chart of accounts, that is, the list of ledger account names and associated numbers arranged in the order in which they normally appear in financial statements: assets, liabilities, owners' (stockholders') equity, revenue, and expenses.
- Production of a new set of financial statements similar to those used in Western accounting.
- Initiation of radical changes in accounting and auditing regulation and methodology. The government approved the principal normative documentation, "Regulation on Accounting and Reporting in the Russian Federation," in February 1992. The Ministry of Finance is largely responsible for the transformation of the accounting system, with the assistance of international institutions such as the UN, the EU, the World Bank, and the IMF and the major international accounting firms.

Current Status of and Trends in Russian Accounting

The main aim of the government's Accounting Reform Program, approved in 1998, is to create a set of national accounting standards based on IAS. At this juncture Russian accounting standards conform to IAS in the following main respects:

- Using a double entry bookkeeping system, that is, recording each transaction as both a credit and a debit
- Maintaining balance sheet continuity
- Recording assets on the basis of the original cost of acquisition
- Taking the going concern principle into account, that is, assessing a company's future prospects based on the assumption that it can stay in business
- Valuing foreign currency assets and liabilities using the prevailing market exchange rate.

As the need for understandable, comparable, transparent, detailed, and reliable financial statements has increased, the government has taken steps to promote accounting reforms. The Institute of Professional Accountants of Russia, which was created a few years ago and became a member of the International Federation of Accountants, is playing a major role in the transformation of accounting, along with the Interagency Government Committee for Accounting Reform. In addition, the government has adopted a resolution requiring audits of major Russian enterprises.

Increasing numbers of Russian companies are switching to IAS, although these standards may require adaptation to Russia's economic circumstances. Russian accounting regulation should be based on various enterprise categories based on the types of owners and on companies' size and capital market exposure. These categories are as follows:

- **Public (open joint stock) companies and other enterprises listed on international capital markets and Russian trade organizations.** Some listed companies are already using IAS or U.S. Generally Accepted Accounting Principles for financial reporting purposes, and are also using national accounting standards for Russian statutory purposes. Others use neither IAS nor U.S. Generally Accepted Accounting Principles for financial reporting purposes. However, given the need for Russian capital market development and the integration of the Russian capital market with international markets, the latter enterprises should switch to IAS.
- **Not listed public (open joint stock) companies using Russian accounting standards for financial**

Still Worlds Apart? Russian and International Accounting Standards Compared

Prime Minister Kasyanov recently announced that every Russian company had to have shifted to International Accounting Standards (IAS) by 2004. Given the inconsistencies that still exist between Russian and IAS rules, this is a formidable task. Under Russian rules:

- The banks enjoy far more discretion with respect to the classification of problem loans, which renders them less transparent.
- The costs of research can be capitalized under certain conditions.
- The revaluation of property, plant, and equipment is allowed, but gives different results than IAS and need not be kept up-to-date.
- The useful life of property, plant, and equipment is usually determined using periods prescribed by the government for tax purposes, which are longer than those for which the assets are expected to be used.
- If investment properties are revalued, they are still depreciated, and the gains and losses are not required to be considered as income.
- Provisions can be established more widely or less widely than under IAS, and there is no requirement for discounting.
- Own shares are shown as assets.
- The classification of cash flows between investing and financing activities in the cash flow statement may be different from IAS.
- Some parent companies do not prepare consolidated financial statements.
- In the definition of control, the ability to govern decisionmaking does not have to be accompanied by the objective of obtaining benefits from the entity's activities.
- Investments in certain securities held for the short term are not required to be carried at the lower of cost and market value or at market value.
- Certain subsidiaries beyond those referred to in IAS may be excluded from consolidation (the final financial statement).
- A subsidiary that is a bank may be excluded from consolidation if it is dissimilar from the rest of the group.
- Certain fixed costs (operating expenses) that have been paid by a company's founder, such as rent, property taxes, and interest expense, can be capitalized, that is, recorded as additions to asset accounts and not as expenses.
- The realizable value of inventories can be measured without deducting selling costs.
- Certain overheads can be capitalized in addition to those related to production.

reporting purposes. The major objective of accounting reform with respect to this category is to develop a set of IAS-compatible national accounting standards, because investors want to have comparable financial information about securities issuers and because of the potential entry of these enterprises into capital markets.. In this context, Russia can study EU experience as the EU is transforming its accounting directives to comply with IAS.

- **Closely held joint stock companies and limited liability companies other than small businesses,** that is, enterprises that either do not have outside owners or whose outside owners are affiliated with their managers. This group should also include 100 percent state-owned enterprises. Enterprises in this category use Russian accounting standards for financial reporting purposes; however, given the lack of people interested in their financial statements as well as disclosure restrictions, they should be subject to less detailed financial disclosures.
- **Small businesses.** These should be entitled to use a simplified form of bookkeeping and financial reporting

Enforcement

A Russian accounting system that meets market requirements cannot be created in isolation from the development of capital markets and an efficient corporate governance model that takes specific features of enterprises with various levels of exposure to capital markets into account. In developed capital market economies stock exchanges and other organized markets are primarily responsible for bottom-up enforcement functions, usually combined with control from above, that is, by government agencies such as securities commissions and other regulators within the corporate governance system.

As concerns the enforcement of accounting standards in Russia, proposed legislation will empower government agencies to exercise control over the preparation and presentation of financial statements by securities issuers, public (open joint stock) companies, natural monopolies, and other enterprises and provide for a set of effective sanctions for breaches of accounting rules; consolidated financial statements will be subject to compulsory audits; professional accounting bodies envisage adopting and enforcing standards of professional conduct that their members will have to adhere to; and markets will exert quality control over the financial disclosures of public companies and of enterprises listed on international capital markets.

The reformers have paid considerable attention to the issue of corporate governance, which encompasses a variety of activities connected with the management of companies. Cross-ownership by banks and industrial companies has tended to blur the lines between governance and accountability. Improved corporate governance is vital for increasing investment by both domestic and foreign investors in all sectors of the Russian economy. One way to foster such improvement is to introduce standards that are based on an analysis of best corporate governance practices. Such standards would apply to all economic entities, but are most important for joint stock companies, where the separation between ownership and management is the greatest, and where conflicts related to corporate governance are therefore the most likely to arise. The final version of the Russian Code of Corporate Conduct was submitted by the government on April 4, 2002.

Educating Accountants

For many years, Russian accountants' primary responsibility was to generate financial information for control purposes, but not for making decisions. As a result, accountants' prestige was extremely low. Accounting training in the former Soviet Union consisted of an odd mixture of different disciplines (accounting, economics, finance, and so on) and training in technical accounting procedures and accounting principles for different types of economic activity With the expansion of the accountant's role, accounting education had to go beyond the traditional undergraduate curriculum to include expanded bodies of knowledge in a variety of related fields. Various educational institutions are now providing training in modern international financial management methodologies, and Russian universities have started to include IAS in their curriculum

It is gratifying to see the radical changes and improvements that have occurred in Russian accounting and auditing methodology in recent years, along with the extensive ongoing work to bring Russian accounting and auditing in line with international norms and practices By 2005 the similarities in theory, practice, and education will likely be even more pronounced. Nevertheless, based on Russia's particular socioeconomic circumstances, divergences in accounting practices will remain

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U.S. Corporate Capitalism on Trial: What Direction Should Cleanup Efforts Take?

By Adolf J. H. Enthoven

A previous article in *Transition*, "The Enron Crisis: Some Lessons for Transition Economies" (January-February 2002), discussed how transition economies should try to prevent a corporate meltdown like the one that caused the demise of Enron by paying close attention to installing well-functioning financial, accounting, auditing, and legal frameworks conducive to the development of their capital and financial markets. In the meantime, new scandals among U.S. corporate management raise the issue of whether the U.S. capitalist system has been eroded from within and is really so impervious to the ethical, moral, and functional deficiencies observed in other countries.

Almost half of all adult Americans own corporate stock, either directly or indirectly. Damage to the system affects millions, and finding a cause is not easy. The culprits, witting and unwitting, include not only immoral executives; compromised auditors and accountants; negligent institutional investors, securities analysts, and lawyers; and uninformed or indifferent directors, but also inattentive government leaders. A range of proposals to reform corporate governance and government oversight are now before Congress Underlying these is a basic notion of morality and ethics that may not have received due attention in either the real world or at educational institutions.

The underlying principles of free markets—transparency and trust—have been the first victims of "crony capitalism," as dramatically illustrated by the scandals involving Enron, Arthur Anderson, Global Crossing, WorldCom, Tyco, and others Too many corporate boardrooms sacrificed trust on the altar of quick and illusory profits intended to generate astonishingly inappropriate levels of executive compensation. Corporations established off-balance sheet partnerships to mask their liabilities and inflate their profits. Executives maximized their compensation with stock option plans that burdened their companies with huge hidden costs and companies gave their chief executive officers massive "sweetheart" loans. Venerable accounting firms looked the other way as companies cooked their books and shredded their own documents to hide their misdeeds Corporations moved their legal headquarters off-shore to avoid taxes.

Laundry List of Remedies

The most important remediable actions proposed for corporate America by both experts and members of Congress fall under the following headings.

1. Corporate Governance

Independent directors on boards of directors should be required to meet regularly without internal executive directors present. Their job is to hold executives to account on shareholders' behalf. With the exception of the chief executive officer, members of corporate boards of directors should not have a material stake in the company. The purpose of a board of directors is to represent the shareholders and not management or themselves Regulations may require companies to set up independent audit committees within the board that have the sole authority to hire and fire auditors and to approve contracts for nonaudit services. Directors and executive officers should be excluded from selling their holdings of company stock while serving on the board.

2. Corporation-Accountant–Auditor Relationship

Congress and the public generally agree that accounting industry oversight needs to be strengthened, while accounting standards should also be reevaluated. The elements of a minimum reform have been proposed that include prohibiting company auditors from doing nonaudit work, requiring the mandatory rotation of auditors, and creating an official oversight body. During the last 10 to 15 years the leading accounting firms have diversified their services to include lucrative consulting for their auditing clients on tax management, merger and acquisition strategy, systems, cost control, and corporate structure. The purpose was to strengthen client relationships, improve profitability, and retain talent that the firm's corporate clients were luring away. The result appears to have been to create a fundamental conflict of interest between, on the one hand, rigorously and objectively scrutinizing their

auditing clients, and on the other hand, currying favor with those same clients to win their consulting business.

Furthermore, accounting firms should be prohibited from both providing internal audit services and carrying out the annual corporate audit. In addition, corporate officers and directors should be prohibited from attempting to influence the scope and work of the auditors. The proposed regulation would also forbid the lead accounting firm partner responsible for reviewing a specific company's audit from working with that client for more than five years. Proponents of reform are also examining whether requiring companies to change auditors regularly would be desirable. Investors may no longer trust the audits of public companies if they see accounting firms providing consulting services to the same client, either simultaneously or at some future date, as a conflict of interest. They consider that a complete and permanent separation of auditing and consulting services is necessary to safeguard the integrity of audits. Accordingly, any firm that serves as the auditor of a company would be prohibited from providing any consulting services to that company.

3. Accounting Oversight

The current U.S. accounting oversight structure is fragmented and, in disciplinary situations, often ineffective. It includes a series of independent oversight and standards groups that work with various state and federal regulators, namely:

- **The Securities and Exchange Commission (SEC)** has jurisdiction over the accounting and audit requirements of publicly traded corporations. Securities law requires that these corporations be audited by an independent firm. In practice, the SEC has left the actual oversight of accounting firms to a variety of state regulators and self-regulating bodies. The SEC has reacted to the recent scandals by proposing the establishment of a stronger public oversight organization under its jurisdiction.
- **The Financial Accounting Standards Board,** a private group of accounting and financial professionals, decides how specific financial items and situations should be treated for accounting purposes. A similar group, the Auditing Standards Board, sets standards for corporate audits. In both cases decisions are subject to SEC review.
- **The American Institute of Certified Public Accountants,** the professional body of certified public accountants, sets the standards for auditor independence and determines whether an auditing firm is qualified to audit a publicly traded corporation.
- **A new private oversight body** has been suggested to establish professional standards for audits and ethics and to regularly review firms to ensure that they are meeting these standards.

4. Financial Statements

Congress has been trying to restore public confidence in the way companies state their earnings, a trust that has been deeply shaken by the continuing scandals and indictments. (WorldCom had inflated its profits by almost $3.8 billion over the past 15 months, following the irregularities and frauds uncovered at companies such as Enron, Adelphia Communications, Dynegy, Tyco International, and Global Crossing.) The rules-driven U.S. accounting standards—as opposed to principles-driven standards—leave a great amount of leeway regarding the application of those rules. Its supporters claim that a principles-based system, which insists on substance over form, is not as easily circumvented.

A proposed law would require top corporate officers to certify personally to the SEC that the company's financial reports are accurate and that all information material to the health of the company has been disclosed. Along with the certification executives are to provide a narrative statement of the factual basis for the correctness of the statements and to disclose any "close calls" management made with respect to accounting treatment. Executives who intentionally misstated their companies' financial reports would go to jail.

5. Public Regulatory Agencies

A new bill in the U.S. House of Representatives creates public regulatory organizations, private entities that would review audits and auditors and take disciplinary action when necessary, immediately reporting their actions to the SEC. Major stock exchanges would be required to list only those companies that had adopted codes of ethics for their senior managers. Companies would be required to disclose off-balance sheet transactions and insider transactions or affiliations and relationships and make public disclosures much more quickly than they have done to date.

6. Compensation for Staff and Management

Stock options are a legitimate and valuable form of employee compensation. (A stock option gives an employee the right to buy a certain number of shares in the company at a fixed "grant" price for a certain number of years

and then "cash-in," that is, sell the stock at a higher market price.) However, stock options should be reported as an operating expense as will be mandated under international and EU accounting standards, otherwise they obscure the company's real worth, misinform investors, and encourage continued false reporting of profitability. Top executives should be precluded from selling their holdings of company stock while serving in that company. They could be allowed to exercise their options, but their net gain after tax should be held in company stock until a certain number of days after they leave the company.

Conclusion

The recent U.S. corporate scandals have seriously shaken public and government confidence in the sound functioning of the U.S. capitalist model. For too long, especially during the booming 1990s, the notion was that the system was working fine, while scandals and misrepresentations were shoved under the rug. Companies made good money and their shareholders tended to be satisfied, while their inflated stock prices were a sign of prosperity to stay. As has now become clear, much of this was a cover-up, and serious deficiencies existed in the system that were not brought out in the open or adequately disclosed by those who knew the facts.

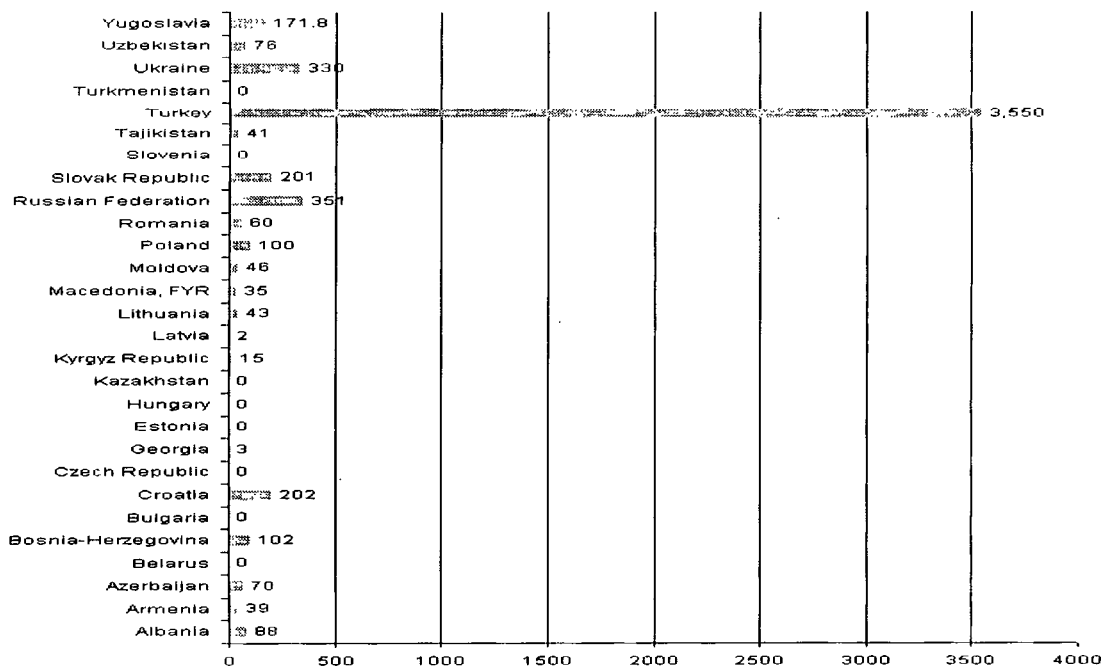
Deliberations in the United States about clamping down on inequities and deficiencies warrant attention by other countries. In their move toward more market-oriented and capitalist economies many emerging and transition economies, while focusing on full deregulation, should ensure that the proper legal, financial, accounting, and economic infrastructures are in place. Loopholes need to be tightened up without killing the more liberal economic system. Morality, ethics, and codes of conduct cannot be learned on the job, but need to be ingrained into nations' moral fiber by means of homes, schools, religious institutions, or other processes. Nations' economic systems depend on the moral and ethical concepts that underpin trust, integrity and transparency.

World Bank/IMF Agenda *(continued)*

Continued from page 15

Including other regions, World Bank lending to member countries rose to $19.5 billion in FY02, a 13 percent increase compared with FY01 (see table 2 for the top 10 borrowers in FY02). "In the months after the horrific events of September 11, the World Bank moved quickly to help developing countries cope with the aftershocks," said World Bank President James D. Wolfensohn. In addition to

Figure 1. IBRD/IDA Lending for the ECA Region by Country, FY02 ($ millions)



financial support, the World Bank increasingly provided policy advice, technical assistance, and analytical services to those member countries grappling with the potential impacts of the September 11 events on their own economies, and on global markets more widely. Specifically, the number of country analytic reports and other advisory products provided to World Bank clients increased from 335 in FY01 to 457 in FY02.

Table 2. Top 10 Bank Borrowers, FY02

Country	$ millions
Turkey	3,550
India	2,190
Brazil	1,566
Pakistan	800
Argentina	735
Mexico	660
Vietnam	593
China	563
Colombia	482
Tanzania	402

World Bank Rules for Hiring Consultants

On August 19 the World Bank clarified those conditions under which the Bank can hire consultants from universities and research institutions in borrowing member countries and the procedures for doing so. The Bank cannot hire government officials and civil servants under any circumstances, because this would compromise the principle of transparency and increase opportunities for abuse. University professors or scientists from research institutes can be contracted individually under Bank financing provided that they have full-time employment contracts with their institutions and have regularly exercised their functions for a year or more before being contracted under Bank funding.

New World Bank Loans to Romania

On September 12, the World Bank approved a $300 million Second Private Sector Adjustment Loan and a $18.6 million Private and Public Sector Institution Building Loan to support structural reforms in Romania. "The new operation will promote reform in the bank and nonbank financial sectors, accelerate restructuring and privatization, and address critical issues, like arrears in the energy sector, while mitigating the potentially negative social impact of the reforms," said Rodrigo Chaves, the Bank's program team leader for the Private Sector Adjustment Loan. The two loans will support reforms in the following areas:

- **Financial sector.** Privatizing the Romanian Commercial Bank, restructuring the Savings Bank, reorganizing the Export-Import Bank to improve its capacity to engage in foreign trade, improving enforcement of the legal and regulatory framework in the banking sector, and developing the government securities market.
- **State enterprise sector.** Divesting the country's largest public sector industrial and commercial loss-makers from the government portfolio, including the ALRO and ALPRO Malumina and aluminum processing plants and the TAROM airline.
- **Energy sector.** Selling controlling stakes of gas distributors and Petrom, the national oil company, to strategic international buyers, introducing new tariff structures, increasing the turnover of payables and receivables to contain arrears, and reviewing the tax regime. A modern legal, regulatory, and institutional framework will be introduced to encourage private sector competition among network industries.
- **Social sector.** Mitigating the social costs of adjustment by making social protection mechanisms more efficient and better targeted. Key goals include providing adequate and sustainable income support to laid-off workers without undermining work incentives and helping laid-off workers obtain alternative employment, pursuing comprehensive reform of the pension system, and improving coordination between central and local administrative units in relation to poverty reduction programs.
- **Business environment**. Removing administrative barriers (permits, licenses, inspections, visas); rationalizing and consolidating institutional fiscal responsibilities and special extrabudgetary funds; improving the tax environment for businesses to encourage more permanent hires; strengthening corporate governance standards, including minority shareholders' rights; implementing sound, internationally recognized accounting standards and financial audit requirements; introducing a more effective system of bankruptcy and liquidation, and adopting a unified corporate income tax law that creates a level playing field for domestic and international investors.

Both loans have a 17-year maturity, including a 5-year grace period, at the World Bank's standard LIBOR-based interest rate. Since 1990 the World Bank has loaned Romania more than $3.2 billion. Its current investment portfolio is worth more than $1.1 billion.

Larry Summers Reflects on the Development Agenda

Larry Summers, president of Harvard, former Treasury secretary, and former World Bank chief economist, offered a few reflections on the development agenda and

made four observations at a luncheon address during the World Bank's Poverty Reduction, Economic Management Network Week in July 2002.

"First, the World Bank is more important to the future than it was to the past. The World Bank and other international organizations are the subjects of almost constant criticism. From the left, they are criticized because their staff is 'too reluctant to wear sandals and stay outside of hotels in the name of being involved with local people.' From the right, they are criticized for absence of tough mindedness, excessive affinity for doing the same things over and over again, and for their excessive taste for the public sector. From other quarters, they are criticized for not caring enough, for seeing complex people problems through the prism of numbers and statistics, rather than underlying human reality. From yet other sources, they are criticized for not being analytical enough, not insisting on the highest standards, and not being prepared to compromise in difficult circumstances. The right thing to say is that there are elements of truth in all of those criticisms, but the greater truth is that the world needs the intellectual resources, the financial resources, and the commitment to global development now more than it ever has in the past. There is an enormous challenge and a moral imperative for all of us to mobilize support for the global development effort. There can be no doubt that there is not a more dedicated, more capable group of people at work on a major problem anywhere in the world than the women and men who work promoting development every day at the World Bank.

Second, it is probably going to get harder to mobilize support for development in the years ahead. The good news is that development is more fashionable as a subject and is a greater concern than it was a few years ago. The needs of aging populations in the major financing countries, and even more, the question of demonstrating that resources are being effectively used to make a positive difference is causing difficulty. [Some say] that problems can only be solved by foreign aid. But the greater emphasis should be on a country's own efforts to create an environment where things can succeed.

Third, development is a process rather than an accumulation. There is a tendency to see development as the accumulation of something necessary. For a while it was infrastructure. For a while it was incentives. For a while it was human capital. There's obviously truth in those paradigms, and each of those investment areas do have high returns, but if you look at the societies that succeed in developing, they are societies where selfishness has been effectively harnessed, where the fairly common individual pursuit of selfish objectives lead to benign social outcomes because of checks and balances in governments, enforced private property rights, incentives for creativity, and entrepreneurship. The real difficulty, in a sense, is that we know how to give people things, but we know less about whether the process will lead to sustained, rapid development. You have all seen the troubling facts. There are various ways to combine these facts, but as one recent set of calculations show, the Marshall Plan equaled 2 to 2.5 percent of the GNP of Europe for four years. Africa has received more than 10 percent of its GNP every year for multiple decades. During my time in government, the Marshall Plan concept was introduced as connected to the proposed experiences of Haiti, Somalia, Rwanda, the West Bank, the Gaza Strip, Bosnia, Kosovo, Cambodia, East Timor, and one or two more countries. In no case, to my knowledge, has rapid and enduring growth been achieved, though these various programs have clearly had important positive impacts. It seems to me that thinking of a process central to development and benefiting from the resources is more important than identifying the magic bullet of the week

Fourth, not everything that is happening in development is shaped by the experience of individual developing countries. What happens in the global economy is profoundly important. What science and technology bring and make available is profoundly important. But at our peril, we ignore those aspects of the broader economic environment. In the World Bank, I was involved in research showing that the growth rates correlation across countries between one decade and the next is close to zero. The correlation in the attractiveness of policy environments is surely very high. Countries that are better in this decade tend to be better now than last decade and will be better the next decade. But the correlation in actual growth rates is close to zero. That reminds us that there is more serendipity of various things than we might at first suppose."

World Bank Compensates Russian Enterprises for Not Producing Ozone-Depleting Substances

In early August the World Bank announced payment of $17.3 million in compensation to seven Russian enterprises that have ceased production of chlorofluorocarbons and halons, the most potent ozone-depleting substances (ODSs), which were used in refrigeration, air conditioners, and aerosols or as solvents and fire extinguishers. Russia was once one of the world's largest producers of ODSs and in 1998 accounted for half the world's production capacity of chlorofluorocarbons and halons. The funds for

the compensation payment to the seven enterprises come from a group of donors organized by the World Bank and known as the Special Initiative for ODS Production Closure. It includes 10 donor countries (Austria, Denmark, Finland, Germany, Italy, Japan, Norway, Sweden, the United Kingdom, and the United States) and the Global Environment Facility. This payment brings to $25 million the group's total compensation to Russian enterprises. The total sum allocated to this project is $60 million.

IMF Report Card on Poland

The Polish economy should grow 1 percent this year and 2.75 percent next year, assuming that inflation remains under control and the central bank will have room to trim its interest rates, said an IMF fact-finding team in September following a visit to Warsaw. An economic expansion of about 5 percent between 2004 and 2006 should be possible as long as the global economy improves, especially in Western Europe. The IMF, noting that Poland's inflation rate is at a record low, joined government calls for the central bank to cut rates again.

IMF Is more Humble, Says Its Chief

IMF Managing Director Horst Köhler said that the IMF had a lot to learn about preventing financial crises. Speaking in Japan, Köhler said that the Fund was now more humble about giving advice to its borrower countries, pointing to the recent failure to prevent the financial crisis in Latin America. "To resolve home-grown problems, no external advice, however sound, and no amount of external financing can substitute for self-responsibility and political cohesion in a society,' he said. "The lessons of the Asian crisis have already led to many important changes in IMF policies and internal culture," Köhler said, adding that there had been "a near-revolution in transparency," as well as a push to accelerate action to prevent financial emergencies. He also said that the international financial system was more resilient today than it was before the Asian crisis, but added: "The fact that it was not possible to avoid the current difficulties in Latin America suggests that we still have a lot to learn."

World Bank's Mammoth Program for Vietnam

The World Bank has approved $3 billion in assistance to Vietnam over the next four years to help keep the country's economic reforms on track as part of the Bank's strategy for Vietnam for 2003-06. The country assistance strategy lays out a lending program of $300 million to $760 million a year to support poverty reduction efforts, focusing on rural and urban development, infrastructure, and human development. "This is the second largest international development assistance program in the world after India [which] reflects the extraordinary potential and opportunities in Vietnam," said Hanoi-based outgoing Country Director Andrew Steer in a statement. He will be succeeded by Klaus Rohland, previously the Bank's Sydney-based country director for East Timor, Papua New Guinea, and the Pacific islands. The World Bank opened its Vietnam office in 1993 and Andrew Steer became the first country director in 1997. The Bank's outstanding lending commitment is $3.8 billion, of which $1.7 billion has been disbursed.

Ukraine: EBRD's New Strategy . . .

Cooperation between Ukraine and the European Bank for Reconstruction and Development (EBRD) will focus on oil and gas transportation, municipal water and heat supply, and small and medium enterprises (SMEs), according to a new strategy for 2003 adopted by the EBRD's board during its September 3 meeting. To facilitate activities by microenterprises and SMEs, the EBRD plans to work through its Microfinancing Bank and provide direct credit lines to several banks, said EBRD Director Yury Poluneev. The EBRD also plans to help the nonbank financial sector, including the development of mortgage finance, leasing, and insurance. For Ukraine, EBRD-supported projects have reached a total of €850 million Those include €180 million for energy; €100 million for agriculture; €35million for municipal infrastructure, mostly water supply; and €10 million for real estate and hotel businesses.

. . . and Consultations with the IMF over Cooperation

On September 11 Ukraine's Cabinet of Ministers started consultations with experts from the local IMF office on possibilities for further cooperation with the Fund after the expiration of the Extended Fund Facility on September 3, announced Deputy Prime Minister Vasyl Rohovy. Earlier, President Kuchma had suggested that Ukraine should gradually switch to nonlending cooperation with the IMF. Ukrainian officials had previously suggested that they may seek a precautionary stand-by or Contingency Credit Line. [Editor's note: The CCL allows countries that have met certain preconditions to augment—at low cost—the foreign exchange reserves they can draw on in a crisis. The knowledge that these resources are available may in itself serve to deter speculative attacks.] In the event, Ukraine increased its foreign reserves to the equivalent of eight weeks of imports, and is therefore in no immediate need of external financing. The World Bank is getting ready to provide Ukraine with a $250 million loan under the Second Programmatic Adjustment Loan.

EBRD Report: Russia Capital Flight Amnesty Unlikely to Succeed

Russian capital held offshore is unlikely to return to the country in large amounts even if the government declares a tax amnesty, said the EBRD. Much Russian money held abroad left the country in violation of its tough currency and taxation laws. The government is considering declaring an amnesty on the money its citizens hold offshore in a bid to bring billions of dollars back home and boost investment in the economy, but EBRD economists said that until the country's investment climate improves, Russians are unlikely to bring their capital home. "Amnesties cannot provide the solution to the underlying investment climate problems," said the EBRD, adding that an amnesty would only succeed "in the immediate aftermath of a fundamental break with past policies" that were responsible for driving the capital offshore in the first place. "Russia is not in a position to claim that now," the EBRD concluded.

An EBRD report authored by EBRD Chief Economist Willem Buiter and Senior Economist Ivan Szegvári said that significant capital outflows are likely to continue over the medium term. Any reduction is likely to be gradual and linked to institutional reforms, such as reform of public administration and the banking sector. The report also said that the government lacks the credibility to convince citizens that it would stick to the terms of the amnesty. Most experts estimate that between $20 billion and $25 billion left Russia each year during the 1990s. Some of the money held offshore was earned illegally through crooked business deals, but a great deal of it is thought to be legitimately earned capital fleeing high tax rates, corrupt state officials, and criminals. Despite three successive years of strong economic growth, foreigners remain reluctant to invest in Russia, and the government's attention has increasingly turned toward Russian capital held offshore.

IMF Recommends That Russia Accelerate Structural Reforms

Russia needs to accelerate reforms of its banking sector, natural monopolies, and public services to reach a high and stable level of economic growth, pointed out Paul Thomsen, director of the IMF's Moscow office, during a recent press conference. Thomsen emphasized that progress in these sectors is needed to attract investment in SMEs. The main goal of structural reforms should be to reduce the excessive intervention of government agencies in economic processes. Investment levels outside the energy sector remain low. The Russian economy remains highly dependent on the operations of a few companies, whose profits in turn depend on the dynamics of commodity prices. With this trend continuing, economic growth in Russia will inevitably slow down once these companies approach their maximum capacity, even if oil prices remain high, warned Thomsen. (*Source:* Polit.Ru, Russia's political news channel).

IFC Equity Investment in Western China-Based Bank ...

The International Finance Corporation (IFC)—the private sector development arm of the World Bank—together with Canada's Scotiabank, signed a memorandum on September 11 with Chinese partners to undertake an equity investment in Xi'an City Commercial Bank (XACB). This first investment in a financial institution located in China's western region will strengthen XACB's capital base and help the bank adopt advanced international managementsystems. XACB was established in May 1997 through the consolidation of 42 urban credit cooperatives. It has a diversified shareholding structure, with 22 percent owned by the Xi'an city government and some local state-owned enterprises and 78 percent owned by more than 450 SMEs and 12,800 individuals, including most of XACB's employees. XACB's customer base is primarily local, private, SMEs. To date this sector has been underserved by the established banking system in China. For more information on XACB (in Chinese) go to www.xacbank.com.

... Assistance with Drafting Uzbekistan's New Leasing Rules...

Financing options for SMEsin Uzbekistan have improved considerably through a new leasing decree developed with the support of IFC experts. Decreed by Uzbek President Islam Karimov at the end of August, the new rules will help increase SMEs' access to credit for business expansion and will remove the significant tax barriers to leasing in Uzbekistan, leveling the playing field for leasing and bank loans. IFC has worked in the leasing sector in Uzbekistan since 1995; was one of the founding shareholders in the first Uzbek leasing company, Uzbek Leasing International; and recently loaned the company $2.5 million to increase its available lease capital. Leasing is a key source of medium and long-term financing for SMEs in transition countries, improving their access to capital by basing their credit risk on their projected generated cash flow rather than on their credit history or collateral. IFC has advised 35 countries on developing leasing, and invested almost $1 billion in leasing operations in 50 countries over the last 30 years.

...and Help Developing Croatia's Mortgage Finance

IFC is supporting Croatian home buyers with a €20 million loan to Erste & Steiermarkische Bank, a leader in Croatian mortgage finance. As part of the agreement, signed on September 3, IFC will provide the Bank with a 10-year line of credit, which will enable it to provide more residential mortgage loans, thereby deepening the mortgage market and offering new opportunities for home buyers The financing follows IFC's provision of a €16 million credit line in 1999 to support Erste & Steiermarkische Bank's lending to SMEs.

IFC/EBRD Initiative to Promote Micro- and Small Businesses in Central Asia

To support micro- and small enterprises in Kazakhstan, the Kyrgyz Republic, Tajikistan and Uzbekistan a $155 million initiative has been launched by the IFC ($45 million), the London-based EBRD ($107 million), and the Swiss Secretariat for Economic Affairs ($3 million). The initiative will give a major boost to the local banking sector, providing credit lines to local banks for on-lending to micro- and small enterprises. The initiative in the four Central Asian countries will help bridge the gap between local banks and micro- and small enterprises, which are currently underserved by existing financial institutions. Selected banks that employ the credit facility will benefit from a comprehensive technical assistance program that will strengthen their lending and operational capacity. More than 500 million poor people around the world run profitable micro-enterprises and often cite credit as the primary constraint to business growth.

Other World Bank Loans

Montenegro: $20 million IDA credit, in part for structural adjustment ($15 million) and in part for energy sector modernization ($5 million). The agreement was signed in early September between Rory O'Sullivan, the World Bank's country manager of the Belgrade office, and Acting Federal Finance Minister Veroljub Dugalic. The credit will carry a 20-year term and a 10-year grace period

Croatia: $25.7 million loan for the Real Property Registration and Cadastre Project, which will help build an efficient land administration system and real property markets. The total target under the project is approximately 250,000 hectares, involving about 1.05 million parcels, and would benefit about 360,000 people, including 110,000 landholders in more than 15 cities, several islands, and other areas by streamlining procedures and reducing processing times.

Croatia. $27.3 million loan for the Pension System Investment Project, which will improve the effectiveness and transparency of the country's pension system and strengthen the capacity of agencies that operate and regulate the new multipillar pension system. Since Croatia joined the World Bank in 1993, the Bank has supported 20 projects with about $1 billion in loans and a number of grants surpassing $17 million.

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Working Papers
http://econ.worldbank.org/

Michael Lokshin and Martin Ravallion, **Rich and Powerful? Subjective Power and Welfare in Russia**, WPS 2854, June 2002, 45 pp.

David Ellerman and Vladimir Kreacic, **Transforming the Old into a Foundation for the New: Lessons of the Moldova ARIA Project,** WPS 2866, July 2002, 19 pp.

This paper is a case study of one of the most successful projects in any country in the Europe and Central Asia region, which also happens to be the poorest country of the region—Moldova The Agency for Restructuring and Enterprise Assistance (ARIA) project shows new ways to attack some of the most intractable problems of private sector development in Europe and Central Asia, to facilitate reorganization and liquidation bankruptcies, and to promote small and medium enterprise spin-offs and new start-ups. The prime mover for these programs is the quasi-public restructuring agency ARIA, which was

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Digital Divide or Digital Diffusion?

By Richard Rose

Studies of the Internet are full of references to a digital divide, referring to the fact that access to the Internet is not equal within or between countries. In several countries more than half the population can access the web. By contrast, in many poor countries both the educated and the uneducated alike lack access. Representative sample surveys can not only identify the percentage of users in a society, but can also reveal the characteristics of people who do and do not use the Internet. Furthermore, surveys yield information about how people use the Internet and yield insight into whether nonuse is due to poverty, ignorance, or lack of motivation.

Since the days when the Rothschild family used carrier pigeons to speed the free flow of information across the principalities of the Holy Roman Empire, information has moved readily across borders. Today the rapid movement of information is central to maintaining the EU's single Europe market. It is also important for labor mobility, enabling migrants to keep in touch with their homes and signaling job opportunities to people who live in places with a high unemployment rate. The free flow of information is important in Transparency International's anticorruption campaigns and, as Karl Popper and North Korea remind us, it is critically important for an open society—and for its enemies.

Internet access is especially important in the transition countries, because the transition process is about opening up a country to the world. The readiness of Central and Eastern European postcommunist countries to apply for membership in the EU is one example of opening up. China's entry into the World Trade Organization and Russia's newly expressed desire to join are other examples. While technology permits information to flow freely, realization of its full potential is blocked by economic, social, and political obstacles. The critical question for transition countries is whether the current divide is more or less permanent or is temporary.

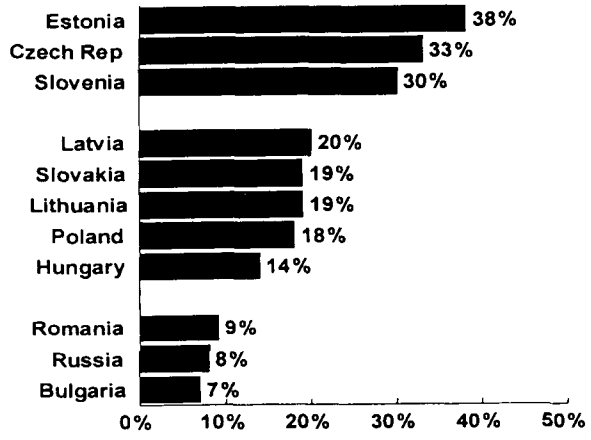
Insofar as diffusion occurs, sooner or later the digital divide will erode. In the case of the enormous gap between Europe and Africa, the Internet did not cause the gap neither can it close it. Within the EU the gaps are substantial, but Internet access is now sufficiently widespread in such countries as Greece and Portugal for catching up to occur as the Scandinavian countries reach the limits of access. What is true of Mediterranean Europe is also true of the postcommunist countries of Central and Eastern Europe and of developing middle-income countries on other continents. As technological progress results in a drop in the cost of standard computer facilities, Internet access is becoming progressively cheaper.

Measuring Internet Use

Computers and telecommunications facilities are necessary conditions for Internet use, but by themselves are insufficient. Use of the Internet requires at least a minimum degree of computer skill. The development of icon-based programs has been a major step forward in promoting computer point-and-click literacy. Governments must not only promote low-cost and high-access telecommunications, but must also allow their citizens freedom to communicate with foreign countries. Where Internet access is growing most rapidly, far more people are signing on than there are PCs. Educational institutions and some public libraries offer Internet connections for multiple users and the market encourages multiple users through Internet cafes. In poor countries the scribe with an ancient typewriter is being replaced in the bazaar by an entrepreneur with a cell phone and an Internet connection that users can pay for by the minute.

When the New Europe Barometer survey asked citizens in 11 postcommunist countries whether or not they used the Internet, their replies showed substantial differences between leading and lagging countries. The leading country was Estonia, where three in eight adults sometimes used the Internet. At the other extreme were Bulgaria, Romania, and Russia , which also lag behind other transition societies on many material indicators of development. However, GDP per capita is insufficient to account for differences in Internet use. Estonians have less money than Czechs or Slovenes, yet their Internet use is higher (see figure next page). The average 20 percent level of use in postcommunist countries places these economies between two extremes of the digital divide: between the African nations and current EU members.

Figure 1. Internet Use in Post-Communist Countries



Sources: Centre for the Study of Public Policy New Europe Barometer nationwide representative sample surveys (autumn, 2001); New Russia Barometer 10 survey (summer, 2001). Total number of interviews: 13,010. For more details see www.cspp.strath.ac.uk

Within a country variations in access reflect age and education differences, for example, more than one-sixth of Russians under the age of 29 are Internet users, while only 1 percent of Russians over the age of 60 use the Internet. Almost one-third of older Russians have never heard of the Internet, but only a small percentage of young Russians are unaware of it. Education is an important influence too. Practically all Internet users have completed at least a secondary school or a specialized vocational school. A university degree doubles the likelihood that a Russian uses the Internet. Employees in new enterprises are most likely to be Internet users, followed by the self-employed. Employees in state enterprises and public employees, including nurses and low-level civil servants, are less likely to be Internet users.

Nevertheless, Internet use is expanding with lightening speed in Russia. Between January 2000 and July 2001 Barometer surveys showed that the estimated number of Internet users increased at about 25 percent a year. This implies that in a few years time about one in five adult Russians will be using the Internet. Russia's dynamism in not unique. Surveys in many countries currently ranked somewhere in middle of global rankings of Internet use show that double-digit annual growth in Internet access is widespread.

At first glance the influence of age and education implies that diffusion of the Internet will require time, until the new, computer-literate generation takes over and the cohorts of older nonusers fade away. However, such an inference is inconsistent with the fact that Estonians and Slovenes have three to four times the Internet use of Russians, even though the three countries' populations differ little in education levels and age structure.

Rapid diffusion of the Internet within a society depends much more on how fast it can spread among laggard groups of the population. The first obstacle to diffusion is ignorance of the web. The annual study of Internet trends ("Face of the Web") by the international research firm Ipsos-Reid shows that even in the poorest countries, Internet awareness is substantial, especially among urban populations. In countries such as Poland and Russia, where the young and educated are already online or about to go online, there are three sets of obstacles. First, many people see no need to use email or the web. Second, many people do not know how to use a computer or lack access to a computer at work or at home. Third, and much less important, is the cost of access.

In countries where one in five adults has access to the Internet, the potential for rapid diffusion is great, because of incentives for people of different ages and education levels to learn to use the Internet. Central and Eastern European countries are moving to a situation in which you can contact many people if you have email access. If one shopkeeper or farmer obtains a competitive advantage by checking out prices of suppliers or competitors on the web, others have an incentive to do the same if they want to stay in business. Families whose members are dispersed across the country or the world can use email to communicate across the generations. Under such circumstances the cost of occasional visits to an Internet cafe become negligible.

Implications

Within a country the diffusion of Internet use reduces inequalities in access to information. It also increases integration across national boundaries, as the web is global in its reach. It enables citizens and organizations in EU accession countries to become part of the mainstream of Europe far faster than could the residents of small towns and rural areas of France and Italy following the establishment of the European Community in March 1957. The Internet will also make it much easier for nationalities with a dispersed diaspora population to maintain contact across continents.

In business, access to the Internet increases opportunities for just-in-time exports. It also enables consumer

goods manufacturers to advertise their wares widely across continents. The Internet can put labor recruitment on a more open basis, for example, enabling every computer programmer in Hungary to scan the web to find out what job vacancies exist in his or her field in Germany.

Political parties have been quick to use the web to publicize their activities, thereby becoming less dependent on the partisan press. Some NGOs are creating a virtual civil society, using the web rather than street demonstrations to propagate their messages and recruit supporters. Whistle-blowers can drop into an Internet cafe to give national publicity to a confidential government document indicating the existence of corruption.

The diffusion of the Internet can turn social capital into virtual capital. In his major work, "Making Democracy Work," published in 1993, Robert Putnam described democracy as being built on foundations of interpersonal trust between people who saw each other regularly in choirs or bowling leagues. While this model may have applied to Tocqueville's rural America, in a United States of 280 million people or a Europe approaching half a billion people, scale stretches the trickle-up theory of interpersonal trust to the vanishing point. The Internet makes it unnecessary for individuals to meet face to face. The impersonality of requesting information or entitlements from the government via the web can be an advantage in societies where the bureaucrats you meet face to face may be passive and unresponsive and the personal touch involves favoritism or corruption. Insofar as the diffusion of the Internet continues, it offers people whose contacts with the wider world were previously restricted by political repression and relative poverty an opportunity to become more readily integrated in an increasingly open world.

Richard Rose is director of the Centre for the Study of Public Policy, University of Strathclyde, Glasgow, and convenor of the Global Barometer Survey Network, which covers Africa, Latin America, and East Asia as well as postcommunist countries. His latest book is Elections without Order: Russia's Challenge to Vladimir Putin (Cambridge, U.K.: Cambridge University Press, 2002), with Neil Munro. For more details see www.cspp.strath.ac.uk.

Europe's E-Readiness Is Closing in on the United States

The Economist Intelligence Unit's New Ranking

"Despite the dotcom bust, the Internet is still reshaping the way companies do business, and countries' e-readiness will be a vital feature of the global competitive landscape." With these words Daniel Franklin, editorial director of the Economist Intelligence Unit (EIU) commented on the release of the EIU's latest e-business rankings. ("E-readiness" is shorthand for the extent to which a country's business environment is conducive to Internet-based commercial opportunities. It is a concept that spans a wide range of factors, from telephone penetration to online security to intellectual property protection. The EIU developed the criteria for the e-readiness rankings with the support of IBM Global Services.)

Altogether 60 countries are included in the list. The United States leads the pack, as it did in 2000 and 2001. However, partly because of changes in methodology and mostly because of developments in countries' infrastructures, regulatory environments, and economies, significant shifts are apparent further down in the rankings. For example, the Netherlands has moved into 2nd place from 10th place in 2001 (see the table), and northern Europe now claims most of the other top spots, thanks not only to sophisticated information technology (IT) infrastructure and high mobile phone penetration, but also to smart government policy and a good overall business environment. Asia, Latin America, and Africa trail further behind, but a few standouts in each region have made significant gains: Venezuela, for instance, improved its ranking from 47th in 2001 to 37th in the current rankings.

The following are among the main conclusions suggested by the new rankings:

- **Western economies take the lead.** North America and Western Europe dominate the top 10 places in our rankings, with Australia the lonely outsider. These countries score highest both because consumers and businesses have embraced the Internet, and because their economic and political stability and openness to foreign

investment make them good bets for all kinds of business, particularly e-business.

• **E-business is less uniformly developed outside Western Europe and North America.** Transition economies have a mixed record: from the 27th place (Czech Republic and Hungary) to the last two (Kazakhstan and Azerbaijan) they are spread throughout the ranking. Singapore and Hong Kong (China) lead the pack in Asia, taking 11th and 13th places, respectively, while Vietnam and Pakistan languish at the bottom of the heap, in 56th and 57th places. In the Middle East and Africa, Israel alone ranks among the top 30 countries.

• **Bigger is not always better**. The United States may rule the roost, but many of the world's largest economies, including France, Germany, and Japan, are outpaced by smaller, more agile competitors, such as the Netherlands, Sweden, and Switzerland. What sets these countries apart is the broad accessibility and affordability of the Internet, thanks to state-of-the-art IT infrastructure and high per capita income.

• **Business culture is decisive**. The United States tops the rankings because of the degree to which the Internet has become embedded in commercial culture. Nowhere is so much business conducted over the Internet so routinely. This explains why the United States scored highest in the category for e-business supporting services (the consulting and IT services and back-office solutions used to facilitate online business), as well as in the social and cultural category, which considers, among other things, the degree of innovation and entrepreneurship in business. It also explains why Singapore and Hong Kong (China) rank as the most competitive telecommunications markets in the world and among the best equipped, yet do not figure among the top 10 countries. While high-grade infrastructure is important, more important is how people use it.

• **Infrastructure is still evolving**. Even top-ranked countries have not yet satisfied consumer demand for fast, cheap, secure, and reliable Internet connectivity. High-speed, broadband services are not universally available,

E-readiness Ranking, 60 Selected Countries, 2002 and 2001

(highest score is 10)

2002 ranking	*2001 ranking*	*Country*	*E-readiness score*	*2002 ranking*	*2001 ranking*	*Country*	*E-readiness score*
1	1	United States	8.41	31	30	Poland	5.52
2	10	Netherlands	8.40	32	33	Malaysia	5.50
3	3	United Kingdom	8.38	33	35	South Africa	5.45
4 (tie)	11	Switzerland	8.32	34	36	Brazil	5.31
4 (tie)	6	Sweden	8.32	35	31	Argentina	5.14
6	2	Australia	8.30	36	32	Slovakia	5.00
7	9	Denmark	8.29	37	47	Venezuela	4.91
8	12	Germany	8.25	38	38	Colombia	4.77
9	4	Canada	8.23	39	40	Peru	4.43
10	8	Finland	8.18	40	37	Turkey	4.37
11 (tie)	7	Singapore	8.17	41	48	Bulgaria	4.25
11 (tie)	5	Norway	8.17	42	43	Sri Lanka	4.05
13	13	Hong Kong China)	8.13	43	45	India	4.02
14	16	Austria	8.10	44	52	Romania	4.00
15	14	Ireland	8.02	45	42	Russia	3.93
16	19	Belgium	7.77	46	46	Thailand	3.86
17	15	France	7.70	47	44	Saudi Arabia	3.77
18	20	New Zealand	7.67	48	40	Egypt	3.76
19	22	Italy	7.32	49	39	Philippines	3.72
20	16	Taiwan (China)	7.26	50	50	Ecuador	3.68
21	21	South Korea	7.11	51	49	China	3.64
22	24	Spain	7.07	52	54	Indonesia	3.29
23	26	Greece	7.03	53	50	Iran	3.20
24	25	Portugal	7.02	54	52	Ukraine	3.05
25	18	Japan	6.86	55	56	Nigeria	2.97
26	23	Israel	6.79	56	58	Vietnam	2.96
27	27	Czech Republic	6.45	57	60	Pakistan	2.78
28	29	Chile	6.36	58	54	Algeria	2.70
29	28	Hungary	6.05	59	57	Kazakhstan	2.55
30	34	Mexico	5.67	60	59	Azerbaijan	2.38

and Internet-ready mobile phones are still in their infancy, even in mobile-crazed Scandinavia.

- **Governments have wide influence**. Internet business thrives when governments have a clear strategy—and money to spend—to develop IT infrastructure. But that is not the only area for official involvement. Successful e-business depends on a strong legal framework that protects private property and encourages entrepreneurship. Increasingly, it also requires Internet-specific legislation. In the crucial category of the legal and policy environment, Australia comes in first, followed by Sweden, Switzerland, Finland, and the United Kingdom. Other countries—even those without a strong e-business culture, such as Chile and Mexico—are enacting smart Internet legislation, recognizing that good laws promote industry growth.

Working in association with IBM's Institute for Business Value, the EIU adjusted the rankings framework to take into account the shift away from the dotcom era's emphasis on e-commerce to the new imperatives of corporate efficiency, security, and global connectivity. The six categories that feed into the rankings (and their weight in the model) are connectivity and technology infrastructure (25 percent), business environment using 70 indicators covered by the EIU's business environment rankings for 60 countries (20 percent), consumer and business adoption (20 percent), social and cultural infrastructure (15 percent), and legal and policy environment (15 percent).

The EIU is the business information arm of the Economist Group, 15 Regent Street, London SW1Y 4LR, www.store.eiu.com.

Occupational Health Hazards Facing China's Workers and Possible Remedies

By Su Zhi, Wang Sheng, and Steven P. Levine

A national law on preventing occupational illnesses finally became effective in China in May 2002. It enables workers to seek legal redress if their employers violate their right to be protected from working in dangerous environments. Earlier, China's health authorities had published a report that focused on employers, who often ignored the necessary protective measures. As a result, health conditions associated with a poor working environment are plaguing a large number of workers. Based on a series of surveys of occupational health risks in township industries, the authors analyze some of the underlying problems.

In 2001 China's Ministry of Health received reports of 13,218 cases of occupational diseases a 13 percent increase over 2000, when 2,352 people died as a result of such diseases. "Due to incomplete reports, this is only the tip of a huge iceberg of health hazards at the workplace in China. The actual statistics are far worse," warns Su Zhi, a Ministry of Health official responsible for implementing the new law. According to a ministry report based on a survey of half of China's 31 provinces, autonomous regions, and municipalities, fewer than 30 percent of workers exposed to dusty environments have received health checks for pneumoconiosis, the deadly lung disease caused by inhaling dust or small particles. Together with chemical poisoning and leukemia, it has become one of the leading causes of workers' inability to continue working at ages younger than normal retirement age.

As a result of rapid industrialization over the past two decades, more than 20 million township and village enterprises (TVEs) have been established and have become a major component of China's economy; however, 60 percent of these have minimal industrial safety measures. Workers employed in industries involving coal production, metallurgy, building materials, nonferrous metals, machinery manufacture, and chemicals run especially high risks of suffering from occupational illnesses. These small and medium enterprises have spread rapidly in rural areas because of their dynamism and flexible ownership structure: they can be collectively owned, individually run, take the form of joint stock cooperatives, or, more recently, can be funded by foreigners. As of 1999 TVEs accounted for 50 percent of total production, and exports produced by TVEs accounted for 40 percent of the national total. In 1999 China had 20.71 million TVEs employing more than 120 million rural workers out of a total national labor force of 700 million. Currently one out of every five rural laborers works in a TVE, and TVEs have absorbed 50 percent of the total surplus rural labor force.

Policymakers hope that TVEs will eventually absorb more than 140 million surplus farm laborers, or some 30 percent of the estimated rural labor force.

Health Risks Scrutinized

To evaluate occupational risks and the occupational health service needs of rural industries, the Ministry of Health and the Ministry of Agriculture carried out a joint study that covered 30 sample counties in 15 provinces. The study was based on an industrial hygiene survey carried out for all industrial TVEs in these 30 counties, but was extended to small workshops owned by individuals or families working together in 8 townships in 4 of the counties. Altogether almost 30,000 entities were involved, and the survey evaluated 3.1 percent of all TVEs.

The survey included monitoring of workplaces as well as physical examinations of workers. Chest X-rays, biological monitoring, and hearing tests were conducted for workers exposed to eight occupational hazards: lead, benzene analogs, mercury, chromium, silica dust, coal dust, asbestos dust, and noise. Workers suffering from occupational diseases were diagnosed according to standard procedures laid down by the Chinese health authorities.

Another survey measured the attitudes of both employees and employers of the same enterprises in relation to improving the occupational health situation and their plans as they pertained to these problems. This survey covered 30 employers and 100 employees from every sample county whose workplaces had to deal with occupational risks. A further survey assessed the availability and quality of local occupational health services to determine whether a disparity existed between available and required services.

The investigators found at least one occupational hazard in 83 percent of the workplaces surveyed, and concluded that about one-third of all employees were exposed to those hazards (table 1). The 10 industrial sectors with the greatest number of workers exposed to hazards are shown in the table. These sectors accounted for 79 percent of all exposed workers in all sectors. The more developed the region, the lower the proportion of workers directly exposed to hazards.

At about 40 percent of work sites where enterprises were not in compliance with national occupational health standards for workplaces, hazard levels were 10 percent above mandated minimums. The compliance rates for levels of three types of dust were all low: 7 percent for silica dust, 29 percent for coal dust, and 0 percent for asbestos. In comparison, levels of chromium, benzene analogs, and lead were closer to mandated minimums. As concerns noise pollution above 90 decibels, volumes were higher at 43 percent of total work sites, with noise at 23 percent of sites being louder than 95 decibels. The compliance rate for noise pollution was only 33 percent. Current standards are 85 decibels for newly established industrial premises and 90 decibels for old ones.

Of 1,780 TVEs with hazardous working conditions, only 42 percent had any kind of ventilation equipment. Of those that had ventilation equipment, only 87 percent reported using it and 81 percent reported carrying out regular maintenance of the equipment. Physical examinations showed

Table 1. The 10 TVE Industrial Sectors with the Highest Worker Exposure to Hazards

Industrial sector	*Number of enterprises*	*Number of enterprises with occupational risks*	*Number of employees*	*Number of exposed workers*
Textiles	1,777	1,537	246,277	110,392
Production of construction materials	3,944	3,830	303,450	107,014
Equipment and machine production	3,532	3,088	227,049	72,651
Plastics manufacturing	2,361	2,051	226,229	49,049
Chemical industry	1,553	1,473	86,716	37,506
Metal processing	2,164	1,836	127,812	35,765
Construction material mining and processing	768	695	52,118	27,515
Coal mining and processing	218	217	22,671	16,834
Electrical machinery manufacturing	925	733	72,677	13,614
Electronic communication equipment manufacturing	548	414	82,554	12,406
Total (A)	17,790	15,874	1,447,553	482,746
Total for all industrial sectors (B)	29,246	24,183	2,108,994	607,922
(A)/(B) (%)	61	66	69	79

that 4.4 percent of all employees had detectable occupational diseases caused by the seven different types of exposures listed earlier. In addition, 11 percent of surveyed employees had illnesses in which the workplace was the suspected, but not proven, cause (table 2).

Ailing Health Services

In rural areas preventive health services are provided by county-level health and epidemic prevention stations (HEPSs), township health centers, and village clinics. In each county the HEPS is the primary center for medical services, supervision, and technical assistance. Within each HEPS a small group (11.6 percent of all professional public health workers in the surveyed counties) is responsible for occupational health services for the county's industries. Because of rapid industrialization in rural areas, most TVEs are unable to access the basic occupational health services offered at no cost by the HEPSs and the Institute of Occupational Health.

For this study the investigators chose five routine occupational health services and supervision activities of county HEPSs as indicators of the adequacy of occupational health resources (table 3). Coverage provided for TVEs was found to be extremely limited, ranging from 1.4 to 36 percent for the five categories of services examined.

Health coverage for TVEs is especially limited in the case of services that require complicated technologies or highly trained occupational health professionals. Other services, such as health inspections, physical examinations of workers, and workplace monitoring, were insufficient because of a lack of resources. In the 30 counties surveyed only 235 health professionals were available at the HEPSs to provide occupational health services, one-third of whom worked part-time. These 235 health professionals serviced the needs of 170,613 state-run enterprises and TVEs with a total of 3.2 million employees. In 1989 the average length of experience for occupational health workers working for the county HEPSs and assigned to TVEs was a mere 78 days.

In 1989 the 30 counties had 895 township health centers, which included 1,736 people whose work was related to preventive, maternal, and child health care. Of this total 993 people were involved to some extent in providing occupational health services for TVEs; however, most had received no formal or professional training in occupational health. County governments' expenditures on health averaged 3 percent of total

Table 2. Rates of Occupational Diseases

Hazard	Number of employees examined	Healthy employees		Sick employees		Suspected occupational illness	
		Number	%	Number	%	Number	%
Silicosis	6,268	6,010	96	75	1.2	183	29
Coal workers' pneumoconiosis	1,653	1,582	96	18	1.1	53	32
Asbestosis	87	66	76	3	3.5	18	21
Chronic lead poisoning	1,085	800	74	45	4.2	240	22
Benzene analog poisoning[a]	3,071	2,916	95	16	0.5	139	45
Chronic chromium poisoning	330	293	89	37	11.0	0	0
Noise induced hearing loss	6,453	4,289	66	633[b]	9.8	1,531[c]	24
Total	18,947	15,956	84	827	4.4	2,164	11

a. Benzene, toluene, and xylene, measured separately.
b. Hearing impairment in relation to sound frequency.
c. Hearing impairment in hearing high frequencies.

Table 3. County Provision of Occupational Health and Safety Services to TVEs

Category	Number of enterprises	Enterprises covered by occupational health services	
		Number	%
Preventive inspections	7,716	106	1.4
General industrial hygiene walk-though	55,461	19,767	36.0
Workplace hazard monitoring	55,461	2,164	3.9
Physical examinations of workers	55,461	1,494	2.7
Help with setting up occupational health recordkeeping	55,461	16,050	29.0

local budget expenditures, that is, disease prevention and health inspections accounted for a mere 0.25 percent of budget expenditures. The amount spent on occupational health services was even smaller.

Few enterprises had health clinics for their workers and 60 percent of employers did not pay for medical insurance for their employees. No compensation of any kind was given to workers with occupational injuries or illnesses in 11 percent of the enterprises. Unlike in state-run enterprises, only a small fraction of TVEs fully covered their employees' medical expenses and compensated them for occupational injuries and diseases.

Promising Pilot Project

Given the continuing rapid development of TVEs and the growing gap between the level of occupational health services that can be provided and the level actually needed, the Ministry of Public Health decided to conduct a further field intervention study using an expert group in the Department of Health Inspection. The expert group has drafted a national field study program for provincial governments that has started as a trial in four counties prior to nationwide implementation The program includes the following:

- Strengthening occupational health supervision and inspection
- Coordinating improved occupational health services for rural industries with the goal of improving general health conditions in the country
- Improving grassroots health organization networks so that they can deliver occupational health services and manage and supervise such services
- Applying appropriate technology for hazard control and personal protection
- Implementing occupational health education programs
- Assuring adequate human resources and better working conditions for those employed in occupational health services
- Increasing local governments' health budgets and the proportion of occupational health expenditures within total health budgets.

A developing, rapidly industrializing country will inevitably face many environmental and occupational health problems during the initial phase of industrialization; however, the belief is that most of these problems can be controlled through preventive interventions by the government and by health workers.

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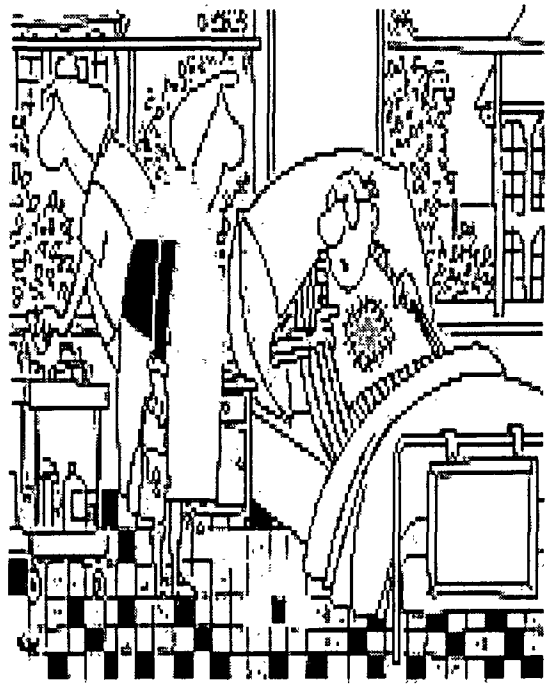
Health Care System Waits for Reform in Hungary



You were right. We should have paid the doctor more for this operation.

From the Hungarian daily *Népszabadság*

Overcoming Textbook Misery in Uzbekistan

By Tony Reed

An innovative textbook rental scheme, based on British know-how and international financing, helps Uzbek students acquire the necessary textbooks and has triggered further reforms in Uzbekistan's education system. The project could be adapted for use elsewhere.

The ability to maintain a regular supply of all the required school textbooks is high on the social policy agenda of all post-Soviet countries, and is one of a handful of critical educational and social issues that deeply concern every parent. In Uzbekistan, the Cabinet of Ministers maintains an interministerial committee that monitors progress on the provision of school textbooks, and the government has borrowed large sums of money from the Asian Development Bank (ADB) to reform school textbook supply as a basic plank of its education reform program.

In 2000 the British Council and International Book Development, a U.K.-based education consultancy group agreed with the Uzbek Ministry of Public Education and the ADB to launch an ambitious program based on British technical know-how and aimed at breaking away from the rigid and highly didactic former Soviet education system. The latter is largely still in place, even though the ideological content of the curriculum was removed immediately after independence in 1991. The central issue in the current reform program has been the urgent need to find an affordable and acceptable method of guaranteeing sustainable supplies of all core textbooks.

Soviet Legacy

In Soviet times students got along well if they had a good memory and were willing to cope with long hours of homework. The basic learning and teaching methodologies were the mechanical memorization of facts, the repetition of grades, and an avalanche of numbers and problems. Most problems had an accepted ideological answer and students had to learn these automatic responses. The system rarely encouraged or valued independent thinking. Educational standards and curricula were unambiguously targeted at the top 5 percent of students, and the rest were expected to cope as best as they could.

School libraries, as understood in the West, hardly existed in the former Soviet Union outside a handful of experimental schools. A typical Soviet school library was a tiny room with a few rows of cramped, tightly packed shelves of ideologically acceptable fiction, which were made available for borrowing to a few favored students. User-friendly, open access libraries or resource centers with a wide variety of attractive materials in different media formats and plentiful study places were unknown

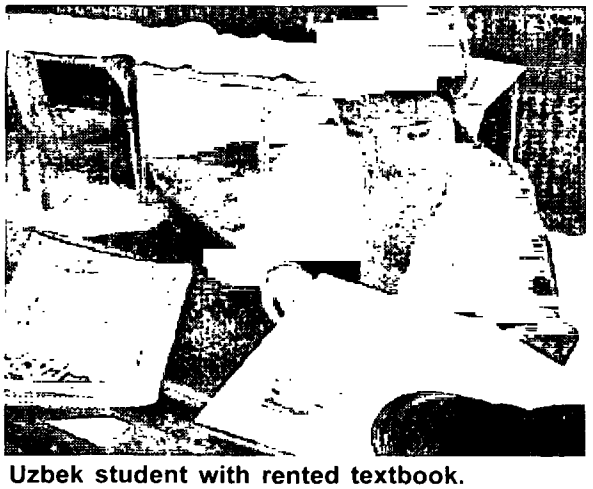
Eleven years after independence, many of these characteristics are still in place. Well-written and relevant teachers' guides to support new approaches to student learning are still rare. Most school libraries in Uzbekistan have received no new library book stocks for at least 10 to 12 years, and there are virtually no computers in schools, and thus no Internet access. Access to information is therefore difficult in most schools. Under these conditions the textbook has become virtually the sole source of subject information for both teachers and students. Typically they are voluminous; crammed with facts, sums, and exercises; dull in design and presentation; and lacking in imagination and learner-friendly strategies and approaches. An Uzbek eighth grade student is provided with four to six times more textbook content than a comparable student in Western Europe. This is not only burdensome to the student, but also extremely expensive.

Free Textbooks: A Distant Memory

Although the latest curriculum seeks the rapid introduction of activity-based, student-centered learning with a clear emphasis on student research and discovery methodologies and encourages creativity, independent thinking, and a questioning attitude, many teachers are untrained in and uncertain about the new teaching and learning techniques. Because of low pay, recruiting new teachers is problematic, and a high proportion of teachers are approaching the end of their careers and have few incentives to adopt new approaches. The curriculum, syllabus, and textbook requirements mean that learning time is desperately overcrowded and allows little time for experimentation, while alternative information is hard to access. So for most schools and most students the lofty objectives of the new curriculum have not been easy to achive, particularly when even the core textbooks have not been available in most schools.

In Soviet times textbooks were loaned to students free of charge. They were supplied with only a single textbook,

bulky enough to last at least four years. Textbooks turned up reliably year after year before the beginning of the school year, and even though they were not designed to be attractive or user-friendly, they were taken for granted.


Uzbek student with rented textbook.

In recent years, however, most former Soviet republics have experienced great financial difficulty in maintaining free supplies of textbooks to schools, and Uzbekistan is no exception. By the late 1990s the government was providing free textbooks only to first grade students. In other grades only a few students could receive free textbooks, borrowing them from school libraries if justified by their social situation. Most students were expected to purchase their textbooks, but this was difficult for most parents, partly because they were expensive in relation to income, and partly because textbook availability was poor and many textbooks were simply not printed in sufficient quantities to satisfy even the reduced demand. In 1999 a set of textbooks for eighth graders purchased from a street trader could cost the equivalent of $15 at a time when the average monthly salary was significantly less than this.

Rental Scheme—New Concept

In 2000 International Book Development and the British Council proposed the introduction of a textbook rental scheme funded by parents and supported by a school-based revolving fund. The Uzbek Education Ministry agreed to test the concept on a pilot basis in 14 districts that included more than 500 schools and 250,000 students, including some of the poorest areas of the country. International Book Development designed the details of the scheme in close association with the ministry and assisted in the preparation of training materials and the delivery of training.

The ADB paid for the printing of pilot sets of textbooks that had been redesigned and respecified specifically for the pilot project. The British Council organized a national publicity campaign to inform all parents in the pilot districts about the scheme. The textbooks were supplied to the schools and the schools collected rental fees from parents and deposited the fees in interest earning textbook accounts in local banks. The fees, approximately $2.20 per student per year, were calculated to accumulate in order to purchase the required replacement copies after four years of use and were under the full control of school textbook committees, which included both teachers and parents. More than 92 percent of parents paid their rental fees (the target collection rate had been set at 70 percent).

Opening a school bank account and accumulating funds under their own control was the number one priority for all the schools in the pilot program. Schools, parents, and district education offices all responded enthusiastically, and districts not included in the pilot demanded that the scheme be extended as soon as possible. By November 2001 the government had approved nationwide introduction of the textbook rental scheme commencing in September 2002.

Parents like the rental scheme because it has greatly reduced their annual cost of providing their children with textbooks. Schools are supportive because they will now have textbooks in sufficient quantities for all students in all core subjects, and because the scheme provides them with school-based funds and decisionmaking capacity for the first time. The government will get rid of its annual headache of financing textbook supplies (except for the very poorest students) and will be able to invest the savings in other high-priority educational needs.

Reforms in the Pipeline

The textbook rental scheme and revolving fund has thus created a chain reaction of educational reform. A new ADB-funded project has now been approved, which will extend the textbook rental scheme into all schools and into a selected number of minority languages in all subjects and at all grade levels over the next few years. The project also specifies investment in library and resource center development, and the Uzbek government is interested in exploring the possibility of adding a computer revolving fund based on parental contributions. A major teacher training investment is expected in 2003. The development of good, open-access school libraries will encourage students to engage in research and to take responsibility for their own learning.

The author is senior consultant on the British Council-led Basic Education and Textbook Development Project in Uzbekistan, e-mail to the council public relations officer: Natalya.Malyova@britishcouncil.uz.

High Priced–Low Priced: Global City Rankings by the Economist Intelligence Unit

Worldwide Cost of Living, the biannual Economist Intelligence Unit survey, compares prices and products in more than 130 cities around the world. Surveys are carried out in March and October each year. The survey's purpose is to provide companies with an unbiased and independent guide for calculating allowances for executives and their families being sent overseas. The Economist Intelligence Unit can calculate indexes based on any one of the cities. The data quoted here used New York as a base index of 100 for comparison purposes.

The survey's main findings are as follows:

- **The capitals of some of the transition economies**, Bucharest, Belgrade, Budapest, and Prague, are the cheapest cities in Europe.
- **China:** Accession to the WTO and cheaper imports have meant that the cost of living in China has fallen over the past 12 months, a trend that is likely to continue.
- **The Americas:** New York (ranked 7th) and Chicago (10th) remain the most expensive cities in North America. Calgary (82nd) is the cheapest in North America, while Atlanta (63rd) is the cheapest in the United States. Following the economic crisis in Argentina and the collapse of the peso, Buenos Aires (120th) has dropped from Latin America's most expensive city to its second cheapest in the space of 12 months. Rio de Janeiro and São Paulo are both comparatively cheap holiday destinations.
- **Africa**: For the first time two African cities are in the top 10. With inflation of more than 100 percent, shortages of goods on the shelves, and a government doggedly holding on to an overvalued exchange rate peg, Harare has risen from 120th a year ago to 4th this time around, joining the perennially expensive Libreville (6th). The South African cities of Johannesburg and Pretoria (both 129th) remain Africa's (and some of the world's) cheapest
- **Asia:** The Japanese cities of Tokyo and Osaka remain at the top, although the gap between them and third-placed Hong Kong (China) has narrowed. While the most expensive cities are located in Asia, the region is also home to some of the cheapest. New Delhi (133rd) is the second cheapest, with a cost of living less than a third of Tokyo's. Although the Australian cities have risen in the rankings, their cost of living indexes have remained relatively static, while the indexes of similarly ranked cities have fallen.

A city's cost of living index will change over time for two main reasons: exchange rate movement and price movement. If, for example, a currency strengthens or inflation pushes up the price of goods, then the relative cost of living in that country will also rise.

Worldwide Cost of Living is now available from the Economist Intelligence Unit online at http://wcol.eiu.com, by telephone on 44-20-7830-1007, or by email at london@eiu.com. For more detailed information on the survey please contact Bill Ridgers on 44-20–7830-1118. For more information on the Economist Intelligence Unit, go to www.eiu.com.

Worldwide Cost of Living, June 2002

City	*Rank*	*Index*	*Rank 12 months ago*
Tokyo (Japan)	1	129	1
Osaka Kobe (Japan)	2	127	1
Hong Kong (China)	3	115	3
Beijing (China)	13	94	12
Shanghai (China)	18	91	17
Guangzhou (China)	26	87	19
Moscow (Russia)	35	83	34
Dalian (China)	36	83	31
Shenzhen (China)	43	81	27
Tianjin (China)	50	77	45
Ho Chi Minh (Viet Nam)	75	68	77
St. Petersburg (Russia)	80	67	89
Kiev (Ukraine)	83	65	85
Baku (Azerbaijan)	86	64	98
Warsaw (Poland)	87	64	89
Hanoi (Viet Nam)	88	64	85
Zagreb (Croatia)	97	62	98
Prague (Czech Rep.)	106	59	108
Phnom Penh (Cambodia)	109	56	115
Tashkent (Uzbekistan)	116	54	102
Budapest (Hungary)	118	51	121
Belgrade (Serbia)	121	45	130
Bucharest (Romania)	123	44	124
Johannesburg (South Africa)	129	38	122
Pretoria (South Africa)	130	38	122
Tehran (Iran)	131	30	131

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Small Businesses Harassed in Russia Despite New Deregulation

Results of a Business Survey

By Oleg Zamulin

The preliminary results of a survey undertaken last spring by the Center for Economic and Financial Research (CEFIR), a leading Russian economic think tank, with the financial support of the World Bank and USAID, indicated that despite the Russian government's efforts to deregulate, the mid-level bureaucracy is still applying regulations that hamper the development of small businesses.

Under a project funded by the World Bank and the U.S. Agency for International Development, in its spring 2002 survey Moscow-based CEFIR started assessing the impact of new regulations on small businesses. The project is to be conducted in several stages to track changes in the level of administrative barriers over time. The first round of surveys covered a large number of firms to assess their experience with the simplified regulations.

Promising Deregulation Program...

The deregulation program is a recent initiative of the Ministry of Economic Development and Trade. President Putin has signed three laws intended to reduce the number of activities requiring licenses, simplify business registration procedures, and protect entrepreneurs' rights during inspections. In addition, the Duma is currently reviewing the Law on Certification and Standards. If these reforms succeed, a dramatic reduction in the regulatory burden is expected, allowing for a much freer and more mobile market economy.

According to one of these new laws, which came into effect on July 1, 2002, the process of registering a new business should take no more than five days and cost no more than Rub 2,000. The government also hopes to establish a "one window" rule, meaning that an entrepreneur would only need to visit a single government agency in order to register.

...But Inspector Visits Intensify

The survey revealed that the specified times and costs of registration are still wishful thinking on the part of the government. On average, registering a business takes about a month at a cost of Rub 5,000, more than double the amount prescribed by the law, and entrepreneurs must visit five or six different government offices to complete their registration. An interesting finding was that a large proportion of firms, especially in Moscow, hire consultants to take care of the registration despite the extra costs incurred by doing so.

In addition, according to the new law no agency is supposed to carry out "planned" inspections more often than once every two years, although the number of "unplanned" inspections is not regulated. However, CEFIR found that the number of inspections was excessively high. For example, although police inspected only 20 percent of the firms interviewed in the second half of 2001, for more than half of these firms the number of visits during that period exceeded one. Although on average the regulatory problems may not seem to be serious, most firms suffer from problems associated with irregular harassment by a particular bureaucrat. A suspicious finding in these cases was that in one-third of these inspections the inspectors could not produce a warrant, and if they fined the business, in almost half of the cases the level of the fine was unclear and was not based on an official schedule. The most striking observation was, however, that the number of inspections increased in the second half of 2001—whether planned or unplanned—compared with the first half, even though the Law on Inspections came into effect in August 2001 and was supposed to reduce the number of inspections. Whether this was caused by a seasonal pattern will only become clear after the second round of the survey.

...and License Formalities Increase

The requirements for various licenses and permits also impedes the growth of small businesses. According to a new law that came into effect in February 2002, a license should cost no more than Rub 1,400 and should be valid for at least five years. Yet the survey showed that only 1 percent of all licenses were valid for five years, and more were valid for less than three years as envisaged in the previous law on licenses, and the median payment was about Rub 8,000.

Enforcing the new law on licensing is hard, because many firms currently possess a large number of illegal licenses. Thus in the second half of 2001 the firms interviewed applied for a total of 700 different types of licenses and 336 types of permits. What these permits are for is not clear, but many of them appear to be illegal and are required by local inspecting agencies. Similarly, half of these licenses and permits are for types of activity not mentioned in either the new law or the old law that was in effect before 2002. Furthermore, whether small firms will really be affected by the significant reduction in the number of types of activities that need to be licensed is not clear: 81 percent of all the licenses that the firms applied for in the second half of 2001 remain in effect under the new law. Further survey rounds will reveal whether such a reduction actually takes place.

CEFIR also examined various interfirm and interregional differences and found that larger firms are subjected to a much harsher regulatory burden than smaller firms, which obviously impedes growth. Younger firms also have a harder time coping with all the requirements than established firms. Intercity and interregional comparisons demonstrate that entry is harder in regions with a higher concentration of industry, but that the number of inspections in such cities is actually smaller, which implies that the larger firms apply pressure on local authorities to limit the entry of new firms, apparently because of their fears of the competition on the labor market. The number of inspections is also smaller in the cities, where local governments are more dependent on their own tax base, and implies that the authorities in such cities have incentives to nurture local businesses.

Survey Design

This project employs two survey instruments, one for older firms and one for recent entrants. The first survey instrument records the burden imposed on firms by licensing and certification regulations, as well as the frequency and length of sporadic inspections by representatives of different government agencies. The second instrument is designed specifically for new businesses, because one of the primary goals of the de-bureaucratization program is to make it easier for new firms to start up. Hence this survey instrument adds a section on registration procedures in addition to sections devoted to licensing and registration.

CEFIR plans to conduct five separate rounds of the survey. The first round was conducted in spring 2002, the next is scheduled for fall 2002, and the rest will take place annually in January 2003, 2004, and 2005. In each round about 100 firms will be interviewed in each of 20 different regions spread across the country. In each region 20 firms are recent start-ups and the rest are established firms.

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Russia's WTO Accession: Scholars See Positive Effects

By Ksenia Yudaeva

Russia applied to the WTO in 1993, although active negotiations and discussions started only a few years ago after President Putin declared that WTO accession was one of the goals of his presidency. The current final stage of negotiations could be drawn out. Russia is reluctant to liberalize its service sector, despite the advantages once accession has actually taken place. Russia's WTO accession was the topic of a recent CEFIR conference held in Moscow.

The conference, Negotiating Russia's WTO Accession: Strategic Lessons from Multilateral Trade Liberalization and Club Enlargement, was held in late June and addressed such topics as the conditions of accession, the current state of negotiations, and the expected effects of the accession for Russia.

Conditions of Accession

As Russia's accession will take place after the Uruguay round, Russia will have to accept more obligations than countries that acceded earlier. The core requirements that all countries that accede to the WTO

after the Uruguay round have to fulfill are as follows:

- Providing complete information about direct state interventions in the economy, including state trading enterprises and price control
- Complying fully with WTO requirements on import licensing, customs valuations, customs fees, rule of origin, technical barriers to trade, food safety, and animal and plant health measures
- Granting Most Favored Nation status to member countries [Editor's note: This was recently changed to Normal Trade Relations status, as this is what it means in practice]
- Eliminating quotas prohibited by the WTO and providing information about others
- Eliminating export subsidies
- Notifying members about trade-related investment measures and conforming to the Agreement on Trade-Related Intellectual Property Rights
- Conforming to traditional requirements, such as reducing tariffs on goods, improving market access for foreign firms in services, and reducing state support to agriculture, although the exact nature of this obligation will depend on the outcome of the negotiations.

Current State of Negotiations

Russia submitted its first market access offer in February 1998, and in spring 2002 the working party completed its report. This means that Russia is entering the final phase of the accession process, in which it will negotiate the conditions of entry and implement the required legislative reforms. However, because of the many disagreements between Russia and other countries, this final stage could take some time to complete.

As an organization whose aim is to liberalize trade, the WTO's aim during accession negotiations is to decrease trade barriers. The Russian case is unusual, because when Russia applied to the WTO, its economy had a different structure from traditional nonplanned economies. A number of sectors such as services did not exist, and many important regulations had not been formally legislated. Even now, after 10 years of transition, Russia still lacks legislation in a number of areas. This situation had a direct consequence for the accession process, because for several years Russia was unable to provide the required information about regulations. Given the absence of formal rules and the set of informal rules that governed the economy, authorities at different levels enjoyed significant discretion. Thus when formal rules were introduced, the authorities failed to enforce many of them. Because of this a number of member countries have doubts about Russia's ability to fulfill its obligations in the future, making the negotiation process more problematic for Russia than the average would-be member.

Tariffs Russia's WTO accession does not coincide with any major trade liberalization. Russia liberalized its international trade in the early- to mid-1990s as part of the IMF stabilization program. It has already eliminated almost all quotas and most tariffs are set below 20 percent. Trade liberalization in Russia coincided with a deep economic decline, and most Russians believe that trade liberalization was one of the major causes of the decline. Thus a number of strong lobbying groups insist on an increase in tariffs during WTO accession.

Price Control Price control is another important impediment to Russia's accession negotiations. Other countries, mainly the United States and EU countries, insist on equalizing prices, which would apply to Russian natural gas sold both internally and externally. This request confronts strong opposition in Russia, because implementation of this measure would significantly increase the domestic price of energy and could once again render Russian manufacturing uncompetitive.

Agriculture Russian agriculture is largely still state owned, thus translating Russian agricultural support measures into traditional WTO classifications of green, red, and yellow light subsidies is difficult. [Editor's note: Red light subsidies, which are contingent upon export performance or on local content, are prohibited because they distort marketing decisions, that is, international trade competition. Yellow light subsidies, the category into which most subsidies belong, are not prohibited, but if they adversely affect the trade interests of other WTO members, they can be subjected to countervailing duty procedures or WTO dispute settlement. Green light subsidies are permitted if used for research and development, regional development, and environmental compliance assistance programs.] Russia will most likely have to bring its system of government support in line with the WTO Agreement on Agriculture and eliminate export subsidies before accession.

Service Sector The most difficult negotiations concern the service sector, most of which is new to Russia, for example, no proper financial sector existed under the planned economy. The current position is largely affected by lobbying groups from this new sector, which use the infant industry argument in their defense. Russia insists on limiting the foreign presence in a number of service

sectors to allow the domestic sectors to develop, and also insists on retaining a state monopoly in some areas. Newly independent regulation agencies, which do not want to be subjected to international accountability, play an important role in this process.

The current Russian accession offer is extremely restrictive. In the banking sector, for instance, the Russian offer not only set limits on the combined foreign equity share and restricts the mode of operation of foreign banks on Russian territory (branches are prohibited), but it also restricts the types of operations foreign banks can engage in (lending is restricted). The situation is even worse in the insurance sector. Foreign firms are prohibited from participating in the country's compulsory insurance schemes, which are vital for foreign insurance companies' presence in Russia.

Another area of the service sector is telecommunications, considered critical for the development of Internet-based

Russia's WTO Entry in Perspective

By Robert M. Stern

The author, professor of economics and public policy at the University of Michigan, in his paper, "An Economic Perspective on Russia's Accession to the WTO," presented at the CEFIR conference in Moscow, reached the following conclusions:

- Russia has made remarkable progress in achieving macroeconomic stability and structural reform, which will help ease the process of adjustment to WTO accession.
- Russia's merchandise exports are concentrated in minerals and fuels and, to a lesser extent, in some categories of industrial products. Russia's imports are concentrated in some categories of industrial products and in agricultural products.
- Russia's exports and imports are concentrated geographically with the EU/EFTA and with the former Soviet republics and members of the former Soviet bloc. Russia's export specialization in minerals and fuels may be of key economic and strategic importance, especially in its intra-European trade.
- Russia's tariffs are, on average, relatively low (see the table). Official tariff rates are substantially in excess of applied rates. Weaknesses in customs procedures may constitute a significant barrier to imports.
- Several aspects of Russia's trade and related policies are at issue in the WTO accession process, including policies pertaining to agriculture, intellectual property, services, standards and certification, investment, government procurement, state trading, and the United States granting Russia permanent normal trading relations.
- Russia's application for General Agreement on Tariffs and Trade/WTO accession has been in progress since 1993, and it is now apparently in its final phases. Pending the outcome of ongoing bilateral negotiations, Russian accession may be completed by the time of the next WTO Ministerial Meeting, to be held in Mexico in the second half of 2003.
- Russia may realize significant economic benefits from WTO accession as a result of reducing its import tariffs and liberalizing its domestic policies. Additional benefits, which are difficult to quantify, may arise from more predictable access of Russian exports to foreign markets and Russia's adherence to WTO rules and agreements, especially the use of binding dispute settlement to protect its trading interests.
- Russia may further realize significant economic benefits from participation in the ongoing Doha Round of multilateral trade negotiations. These benefits could be considerably greater than those that would result from preferential trading arrangements with CIS members and with the EU.

Average Official and Applied Tariff Rates on Russian Imports, 1996-99
(percent)

Tariff rate	*1996*	*1997*	*1998*	*1999*
Nominal official weighted average tariff rates	14	14	12	8
Applied tariff rates (actual duty collected/value of imports)	4	7	7	5

Source: Adapted from M. Gorban, S. Guriev, and K. Yudaeva, *Russia in the WTO: Myths and Reality*, CEFIR and Club 2015, Moscow (2001, p. 6).

The complete analysis, published as WDI Working Paper no. 472, can be found at www.wdi.bus.umich.edu.

businesses. New technologies that appeared in the last 10 to 15 years, such as mobile phones, broke the former position of this sector as a natural monopoly; however, the Russian offer is still based on a natural monopoly view of the sector. Rostelecom, the incumbent Russian telecommunications firm, is supposed to keep its monopoly on long distance and international telephone services until 2010. Foreign operators can only provide services at the local level and are not allowed to have more than a 25 percent equity share when providing resale-based services and 49 percent when offering facility-based services. This offer appears to be completely unacceptable for the WTO, which requires a shortening of the period before foreign competition is allowed and an increase in the limits on foreign equity shares. Moreover, the foreign presence in some sectors is higher than the proportion proposed in the offer, for example, in mobile telecommunications, and foreign counterparts require a drop of all foreign equity limits in sectors where foreign providers are already allowed.

Long-Term Gains

Russia will be expected to introduce new and more transparent regulations, especially in the area of international trade in goods and services. This would certainly lead to major improvements in the business climate and would have a positive influence on Russia's economic growth. Protectionists, however, are criticizing this decision, claiming that accession will cause a drop in Russia's GDP, with their estimates ranging from a modest 1 percent decline to significantly larger numbers.

Such forecasts are based on a partial equilibrium view, which does not take into account the fact that the demand for imports would be compensated for by the supply of exports. General equilibrium models, which are better suited for forecasting the effects of the accession, predict that the effect of the accession will be positive and that most of the gains will result from the liberalization of services. Model-based computations show that the total medium-term gains of Russian accession to the WTO will amount to 6.8 percent of Russian consumption (3.2 percent of GDP), while the long-term gains could be as high as 54 percent of consumption or 25 percent of GDP. Almost 70 percent of these total gains are due to improved access for foreign investors to the service sector (4.7 percent of consumption in the short run), while tariff reduction amounts to an additional 25 percent of total gains (1.7 percent of consumption). The rest of the gains arise from productivity effects and improved market access for foreign firms in the manufacturing sector.

Econometric studies using firm-level data provide some additional insights about the productivity effects. Trade liberalization, especially an increase in inflows of foreign direct investment, lead to productivity increases among Russian firms, both because of restructuring under increased competition pressure, and because of improved quality of imports. The evidence suggests that the entry of foreign direct investment in downstream sectors has positive effects on domestic suppliers, which could mean that increased foreign direct investment in the trade sector could have positive spillover effects on industrial firms.

Thus even though Russian accession is supposedly at its final stage, many problems remain and the process could take much longer. Ironically, the greatest gains from accession would result from liberalization of the service sector, which is the sector Russia is most reluctant to liberalize.

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Transition Meets Development

Economists Debate Convergence during Riga (Latvia) Conference

By Romans Pancs

In what was Latvia's biggest academic event in economics, the Seventh Annual Conference on Transition Economics, held in Riga and organized by the Centre for Economic Policy Research (CEPR) and The William Davidson Institute (WDI), offered three days of presentations, panel discussions, and policy sessions during June 20-23, 2002. A central topic of debate was the convergence of the economics of transition and development economics and their common place within institutional economics. This year's meeting also made a special effort to bring together the new generation of local economists, with a special session of presentations by Baltic Ph.D. students studying at leading Western universities. This article focuses on some of the presentation and debate highlights.

In his keynote speech, Timothy Besley of the London School of Economics described development economics and outlined its intersections with the economics of transition, including the unifying theme of poverty reduction. According to Besley, the incidence of poverty is extensive—about 1 billion people worldwide live on less than $1 a day—and development economics might be described as good economics when applied to poverty reduction. As for the theme of the conference, Besley suggested "development meets transition," with the consensus of researchers in both fields of economics on the importance of getting institutions right. Moreover, both fields draw on public economics to help decide what good policies are and how these might be implemented, and both fields acknowledge the need for better subnational data to study incentives and behavior.

At the subsequent academic roundtable discussion, Jean-Philippe Platteau of the University of Namur defined the role of development economics as facilitating an economy's adaptation to emerging new opportunities. The ingredients for successful adaptation—and the subject of development economics—are the establishment of trust and honesty and the development of informal networks. Gérard Roland of the University of California at Berkeley noted that Adam Smith's question, "How do countries get rich?" (and thus reverse poverty), is also the defining theme in the economics of transition. Law and its enforcement, ownership, and proper constituencies—in short, institutional economics—matter no less than liberalization. The convergence of development economics and transition economics owes much to the events of the 1990s following the disintegration of the former Soviet Union. As for drawing boundaries between fields, most scholars agreed that this was not particularly important as long as good economics was being pursued.

A number of papers were devoted to China, which in the words of Yingyi Qian of the University of California at Berkeley "has been meeting transition for some 25 years," and is regarded as a developing economy by some, a transition economy by others, and both by many. Empirical research on growth, privatization, inequality, and financial markets was presented that drew on the experiences of China, India, Russia, the Baltic countries, and Central Europe. Theoretical work on law enforcement, illegal migration, and trafficking was found to apply to both developing and transition countries. The policy issues that were most relevant to both disciplines, such as ending illegal human trafficking, aroused the most heated debates in the context of China

The policy panel on Ten Years of Exchange Rate Regimes was devoted to policies in Eastern Europe and coincided with the 10th anniversary of the reintroduction of the Estonian kroon Peter Bofinger of Würzburg University took issue with the view that corner solutions for exchange rate policies are the best (either free floating or fixed parity) Managed floating, a targeted exchange rate combined with capital mobility, has performed quite well in Hungary, Poland, and Slovenia, while a fixed exchange rate has failed in the Czech Republic. Märten Ross of the Bank of Estonia argued, however, that the Estonian solution of fixing the kroon to the German mark and adapting the currency board system was a pragmatic and relatively successful decision and a credible one, except for some doubts during 1997-98.

Rumen Dobrinsky of the UN Economic Commission for Europe provocatively suggested that exchange rate experience during transition has corresponded exactly to what textbooks have taught us The financial crisis in Bulgaria was due to the accumulation of huge deficits, and similar crises occurred in Russia in 1998 and in Argentina this year. Differing opinions about this topic are perhaps best reconciled by a remark by Paul Seabright of the University of Social Sciences of Toulouse from his presentation on bank performance in transition economies: "Can we tell a crisis coming? Yes, but only in retrospect."

Both theoretical and empirical papers addressed such topics as inequality Erik Berglöf of the Stockholm Institute for Transition Economics and Patrick Bolton of Princeton University built on observations that inequality hampers growth in many countries, while countries with a large middle class enjoy better economic performance and law enforcement. In their theoretical paper the authors assumed that the poor are less interested in investment protection and more in redistribution through taxation, while the rich can protect their investments themselves and can even benefit from expropriation under weak law enforcement. Hence in such an economy the middle class is a necessary but an insufficient condition for rule of law enforcement. More interesting, the government can choose not to enforce the rule of law even when it has the capacity to do so, and financial development may permit private or government consumption to crowd out investment, thereby undermining rule of law enforcement. Jan Svejnar of WDI noted that higher income levels can compensate for the lack of equality by allowing relatively poor households into the fold of investors, thus making them interested in law enforcement.

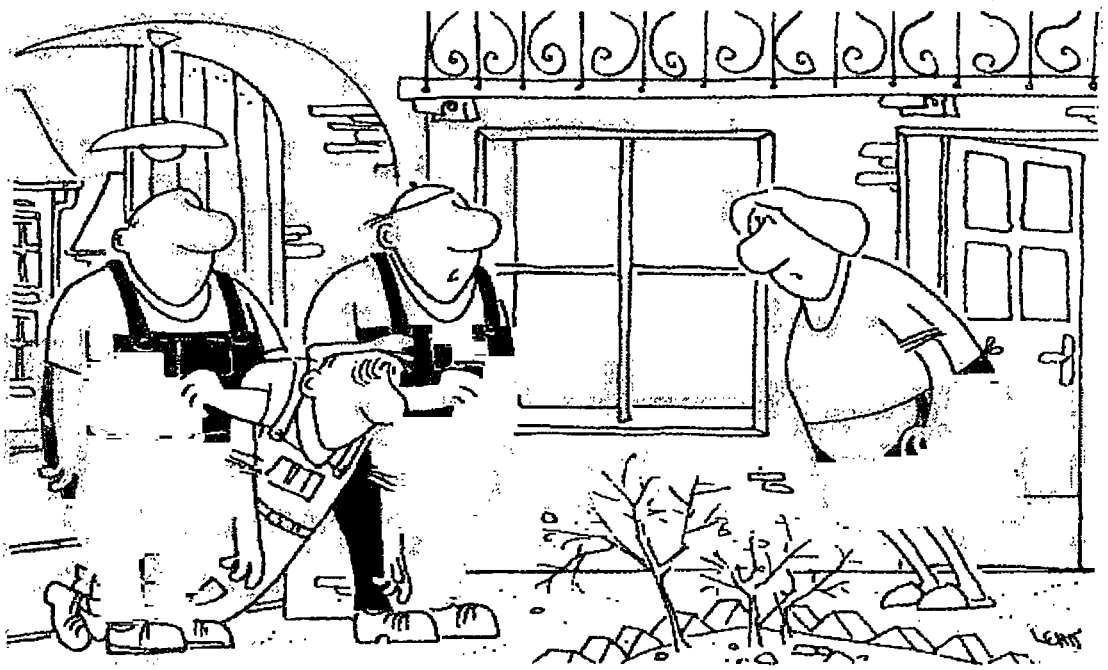
Claudia Senik of DELTA in Paris studied the impact of inequality on individual sentiments in Russia. She observed that on the one hand, people may have a quasi-aesthetic preference for more equal distribution of income, but on the other hand rising inequality, as in Russia, can be interpreted as a positive sign of future prospects (the "tunnel effect"). Senik's estimation showed that the progress of peers is interpreted as good news in Russia, even if it is associated with increased inequality, so that reference income serves as an information category. For Jan Svejnar the policy implications were obvious: government money should be spent to provide opportunity rather than to promote equality. Ksenia Yudaeva, however, was skeptical about the tunnel effect: from her driving experience she learned that Russian drivers are furious, not delighted, when they learn that they have chosen the slower lane.

Young economists from Estonia, Latvia, and Lithuania presented their latest research at parallel sessions. Dmitri Koulikov of Aarhus University introduced a new class of long-memory models. The new process can be used in volatility modeling and in high-frequency financial data econometrics. Martins Kazaks and Duo Qin from Queen Mary University in London assessed the vulnerability of the exchange rate of the Latvian lat with respect to external currency shocks and found that the strongest impact came from transition economies. Furthermore, the Estonian kroon may act more as a transmission port for currency shocks than as an original source of shocks because of the openness of the Estonian economy.

Neringa Jarmalaite of Heriot Watt University investigated the relationship between the prices of securities and future earnings in Estonia, Latvia, and Lithuania during 1995-2000. The challenge of working with Baltic data was to cope with different accounting practices and insider trading in an environment characterized by low liquidity and lack of forecasts by analysts. Jarmalaite established that prices lead earnings, which is consistent with a broad hypothesis of the effects of insider trading.

Romans Pancs, a CEPR rapporteur for the conference, is a Baltic International Centre for Economic Policy Studies (BICEPS) researcher and will be a graduate student in economics at the London School of Economics in 2002-03 as a Latvian holder of a Chevening scholarship. The papers by Baltic Ph.D. students have been compiled in a special volume that is available from BICEPS. The full program is available at http://www.biceps.org.

Trade Unions' Limited Role



Activists: "The owner had him fired and beaten up, but we brought him home!"

From the Hungarian daily *Népszabadság*

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The Hazards of Transplanting Education Reform

A View from the Classrooms of Postcommunist Schools

By Johanna Crighton

Before transplanting Western teaching strategies to the former communist countries under the banner of reform, one has to be clear about the hazards of culture-free transplants. Traditional, teacher-led methods, if balanced with group work and exercises, could develop a firm grasp of facts, fluent and articulate oral responses, confident blackboard performance, and, above all, discipline. One can then argue whether this fosters the kind of creativity, independence, and problem solving skills prized so highly in the Western cultural context.

After 12 years of transition, schools carry on much as they always have, with the best still delivering high-quality education against all the odds, but for most, the cracks are beginning to show. The plain truth is that many postcommunist schools are now more concerned about survival than change, as are most communities, families, and children. The unchanging classroom has become a symbol of comfort and stability, presided over by middle-aged women tired of reform without resources, who see their first duty not as innovation, but the safekeeping of children, the maintenance of old-fashioned values like discipline, and the unchanging "correctness" of textbook and timetable in a sea of chaotic change.

Stages of Reform

Countries emerging from the Soviet past tend to go through the following series of reform phases:

- **The first stage is shaped by initial euphoria about newfound freedoms as the controls of the past collapse**. There is an intense interest in reaffirming the traditions and structures that preceded external domination, a proliferation of new initiatives, and a conviction that decentralization is the answer to most—or even all—problems. This early stage often involves a high degree of participation by external agents, such as donor agencies, international NGOs, and religious groups, each advancing its particular view of needed change.
- **The second stage is often a reaction to the initial proliferation and decentralization.** Efforts are made to regain national leadership and to establish standards and accountability for newly decentralized functions. The challenge is to achieve a degree of rationality and coordination among multiple initiatives. Yet, as with many of the early initiatives, the new frameworks tend to be externally conceived and sector specific. Progress is measured more in terms of how well top-down projects are implemented than on how the education system itself (students, teachers, schools, and institutions) are changing. Reforms still lack strong connections with the country's traditions and culture, and often do not reflect a genuine sense of ownership by the nation's political leadership. Because they tend to be sector specific, focusing, for example, on vocational or preschool education, they lack overall coherence.
- **The third stage seeks to achieve a closer match between the early, externally conceived initiatives and the country's own traditions and unique circumstances**. Many countries are revising the laws they initially adopted after 1990 to reflect more home-grown priorities and values, and to focus more closely on retaining efficiency and quality controls over a diversifying system. However, this third stage is also characterized by reform fatigue, especially where the fabric of school life has worn thin through a chronic lack of resources. Most postcommunist school systems now find themselves in this third stage.

One major problem throughout the region is education funding. In general, public financing of education is poor, amounting on average to 3 to 4 percent of

GDP, sometimes even less, while OECD countries, on average, spend 5 to 6 percent of GDP on education. Foreign aid is not always sufficiently organized, nor is it properly coordinated or sustainable. Nearly all public resources are allocated to teachers' salaries, and almost entirely for pre-university education. Funds for school equipment amount to 2 percent or less of public funding for education or less in Croatia, Moldova, Montenegro, and Romania, and investments total 3 percent or less in Macedonia, Montenegro, Romania, and Serbia. Chronic underfunding erodes the quality of education, especially in education systems that were clearly designed for a much higher level of public financing.

Constraints of Reform

In the day-to-day life of most ordinary schools, reform is not the main issue. Asked what their preoccupations are, principals are likely to say repairs, firewood, and salaries, not standards, curriculum reform, or decentralization. Money, of course, has been the main limitation. Not enough is coming from central governments, and what little does come is barely enough to keep the school doors open and the roof from leaking. Charging fees for compulsory state schooling is both morally and legally suspect, although many schools now find that they must charge for supplies, extra activities, and sometimes books to make ends meet.

Thus the notion of school autonomy has little practical meaning. In the heady days after 1989 many envisaged a new type of autonomous, empowered school as the key to creating a new society brimming with initiative, energy, and critical thinking. The temptation to go for broad, radical reforms across the entire system was strong, but these first bold efforts bore little fruit. While the approach was understandable, it inevitably ran into problems, because the emerging political, institutional, legal, and social fabrics were (and still are) too fragile to support radical change of this kind.

The limits of educational reform are therefore set by constraints imposed by the largely unreformed environments in which systems are trying to operate. For example, decentralization efforts will founder in a society that remains centralized in all its institutions, expectations, and social behavior. With hindsight, many of the impediments to reform were inevitable, but the first reform projects tried to do something that had not been done before in an environment that was still in a state of post-traumatic shock.

Changeable Reforms

Trends and fashions in education—whether or not announced as reforms—are as changeable as weather patterns, and are pushed by the winds of political and social change. Some pass by almost unnoticed; others burst upon classroom life with sudden force. In England, for example, the 1967 *Plowden Report* made thousands of primary school teachers rearrange classroom furniture so that children could work in groups, pursuing projects or working at their own pace. In the egalitarian 1960s, "progressive" teaching became classroom orthodoxy, replacing the traditional "chalk and talk." The much-feared 11-plus exam—taken by pupils at the end of primary school at the age of 11 to determine their academic future—was declared unfair, because research showed that it tended to be the richest rather than the smartest children who passed the exam.

This was the message to English schools throughout the 1970s and 1980s, until more and more insistent concerns were voiced about falling standards and a steady decline in student achievement. A 1996 report on primary school teaching in the United Kingdom, coupled with international research on primary school effectiveness, prompted the chief inspector of schools to instruct teachers to adopt whole-class teaching strategies used in "successful" countries like Germany, Switzerland, and Taiwan (China). The new orthodoxy of effectiveness involves whole-class teaching for at least half of class time in each subject; daily literacy and numeracy hours; and new powers for the chief inspector to intervene directly in failing schools, if need be with the help of management consultants from outside the school system. Maintaining discipline, acquiring solid mental arithmetic skills, learning to read and write accurately, giving plenty of homework, and increasing expectations comprise the current ministerial credo.

This credo finds a ready echo in the United States, where most states are adopting more demanding educational standards in the wake of embarrassingly low performance by American schoolchildren on international mathematics and science tests. The underlying assumption is of a conclusive, causal relationship between national economic performance and classroom teaching methods, and the message to classroom teachers is decidedly conservative.

Wrong Message from the West?

Ironically, this return to traditional teaching and learning strategies in the West is occurring just as progressive

approaches are spreading eastward in first- and second-stage reforms, often driven by external donors. Teachers deprived of years of contact with Western trends are, quite naturally, curious about what innovations have arisen, especially when they offer scope for teachers' long-suppressed creativeness and professionalism without placing too many immediate demands on schools' material resources. Grouping children around tables rather than in serried rows, allowing them to work together, and integrating learning across traditional subject lines all tend to give teachers and children a sense of renewal, excitement, and optimism even where schools are crumbling and classrooms are cold. But teachers might think twice before abandoning home-grown traditions that have, on the whole, served students well—traditions whose disappearance is being lamented by many in the West.

The lesson here is that before transplanting teaching strategies under the banner of reform we need to be clear about the relationship between pedagogy and culture. Consciously or not, teachers everywhere use the strategies best suited for conveying certain cultural messages about what learning is about: whether knowledge is absolute or provisional, when ideas should be accepted or questioned, about the nature of "truth" and authority, about acceptable behavior for success in learning.

Classroom observations in many former communist countries show teachers using traditional, teacher-led methods. In the worst cases this produces an unnerving culture of passivity. Yet in the best cases whole-class teaching is alive and successful. A diverse mix of teacher-led learning, balanced with group work and exercises, will develop the kind of performance skills still most highly valued: a firm grasp of facts, fluent and articulate oral responses, confident blackboard performance, and, above all, discipline. We can then argue whether this fosters the kind of creativity, independence, and problem solving skills we prize in our own cultural context. The hazards of culture-free transplants are obvious. Children in some of the countries of Central and Eastern Europea (CEE) that participate in large-scale international comparisons, do better than their counterparts elsewhere in the world, often embarrassingly better considering the huge differences in per pupil expenditures and facilities (see table).

Active learning is not an option in small classrooms where children are crammed three to every two-seater desk and the teacher barely has space to stand near the scratchy blackboard. Self-directed, project-based learning is not an option in a school without an atlas, a dictionary, an encyclopedia, room for children to work, or homes without books. Where schools work in two, or even three, shifts a day, teachers cannot use walls to display learning exercises and children cannot use desks to store work in progress. Where large numbers of teachers are unqualified, underpaid, unmotivated, or absent, exhortations to innovate will be resisted and resented. Where efforts to slim down an overloaded curriculum

Mathematics and Science Literacy Average Scores of 15-year-olds, by Country, 2000

Mathematics literacy		Science literacy	
Country	Average	Country	Average
Japan	557	Korea, Republic of	552
Korea, Republic of	547	Japan	550
New Zealand	537	Finland	538
Finland	536	United Kingdom	532
Australia	533	Canada	529
Canada	533	New Zealand	528
Switzerland	529	Australia	528
United Kingdom	529	Austria	519
Belgium	520	Ireland	513
France	517	Sweden	512
Austria	515	Czech Republic	511
Denmark	514	France	500
Iceland	514	Norway	500
Sweden	510	**United States**	499
Ireland	503	Hungary	496
Norway	499	Iceland	496
Czech Republic	498	Belgium	496
United States	493	Switzerland	496
Germany	490	Spain	491
Hungary	488	Germany	487
Spain	476	Poland	483
Poland	470	Denmark	481
Italy	457	Italy	478
Portugal	454	Greece	461
Greece	447	Portugal	459
Luxembourg	446	Luxembourg	443
Mexico	387	Mexico	422
OECD average	500	OECD average	500
Non-OECD countries		Non-OECD countries	
Liechtenstein	514	Liechtenstein	476
Russian Federation	478	Russian Federation	460
Latvia	463	Latvia	460
Brazil	334	Brazil	375

Average is significantly higher than the U.S. average
Average is not significantly different from the U.S. average
Average is significantly lower than the U.S. average

Source: OECD, Program for International Student Assessment (PISA), 2000.

result in fewer hours on the compulsory timetable, teachers will fear a loss of income or status With ministers and their agendas changing every six months, with several parallel reform projects descending on schools at once, with some prestigious schools declared pilot or model ones and thus given computers or science laboratories while others have no running water, reform becomes no more than externally-imposed, piecemeal change. The result is often a sense of fear and unfairness rather than a spirit of renewal and opportunity.

Recommendations

Many problems are common across CEE, but few common solutions are available. The following recommendations are therefore general rather than specific to any transition country:

- Make concerted, strong efforts to increase education's share in national and local budgets Postponing essential investment in education is borrowing against children's futures.
- Shift the role of ministries from micromanaging the system to setting policy and monitoring quality linked to explicit standards.
- Develop a comprehensive strategy for the entire education system based on a philosophy of learning for all. This includes children across the ability range, children with special needs, and children from ethnic or linguistic minorities or from poor families. Giftedness is only for a few, but achievement is for everybody.
- Pay more attention to the emotional needs of children (and their teachers) who have been traumatized by war, conflict, displacement, and family breakdown. No community can be expected to function normally in abnormal conditions Expert help may be needed.
- Develop educational leadership at all levels.
- Renew and slim down curricula and ensure adaptability to a changing job market, but avoid "relevance" in the narrow, utilitarian sense of the past, especially in vocational education and training.
- Improve teachers' status, development, career structure, and salaries, but evaluate their performance and ensure that teachers and schools are held accountable for the quality they provide Hire and retain only the more competent teachers, and pay them better
- Focus on learning outcomes rather than on maintaining the system for its own sake
- Ensure that any selection process at any point in a child's school career is fair and transparent and is not weighted in favor of those whose families can pay.

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Decentralizing Education in Central and Eastern Europe—Does It Make a Difference?

By Kenneth Davey

The governance of education in CEE has been subject to constant change and contention over the last decade. The boundaries of responsibility between state, local self-government, and individual schools have been shifting, and are still far from clear in most countries. The jury is still out, but it is clear that governments should develop the capacity for normative supervision and delegate a high degree of responsibility to school management while exercising selective intervention and support.

Does decentralization make a difference? A recent study by the Local Government Policy Partnership, a policy research network funded jointly by LGI and the U.K.'s Department for International Development, has looked at the management and funding of schools in the Czech Republic, Hungary, Poland, and Slovakia.

Four Countries, Four School Systems

The report comprises four case studies. In Hungary the responsibility for managing and financing preprimary, primary, and secondary education was abruptly devolved to local government in 1990; in Poland similar responsibilities were progressively devolved over a nine-year period to 1999; in the Czech Republic the state and local governments have shared responsibility for primary education since 1990 and for secondary education since 2001, with the state paying teachers; and in Slovakia the state retained the entire responsibility for education until partial devolution to local governments in July this year The report describes these varying frameworks in detail and attempts to assess

their impact on the effectiveness, equity, and efficiency of the school system.

In all these countries the environment for reform has not been helpful. Their school systems had to respond to significant declines in child population, to changing demands in employment opportunities, and to financial stress born of fluctuating economic fortunes and a shift from public to private consumption. All four systems have had to respond to changes in the labor market, which is demanding more general secondary education at the expense of manual training and the development of new curricula, including such skills as languages, business management, and information technology.

Some government-led restructuring has taken place in each country, but the report suggests that most change has been generated by the schools themselves, particularly where their funding is based on student numbers. Schools seem to enjoy more freedom to transform and innovate in a decentralized system—nearby town halls are easier to persuade than distant ministries—although the evidence is far from conclusive. The greatest experiment has been in Hungarian cities, where the responsibility for primary and secondary education is not split, and the restructuring of individual schools has freely crossed this boundary.

Impact of Devolution

Whatever the degree of decentralization the state, principally through a ministry of education, retains a duty to sustain consistency and quality. The four countries have shown varying degrees of difficulty in developing this capacity. State bureaucracies have experienced difficulties in adjusting their behavior from administrative control to monitoring and to promoting standards. This has been reinforced by the absence of common examination systems by which school performance may, at least to some extent, be assessed. Inspectorates have even had to be reinvented in Hungary, where they were abolished in the mid-1980s.

Quality

Educational quality is notoriously difficult to measure. The four case studies convey a mixed and muted verdict on changes in the quality of schooling over the last decade. Testing of school leavers' knowledge levels suggests some decline, although more in literacy than numeracy. This has been associated with a growing differentiation in school performance. This seems to be most prevalent in the case of the upper grades of primary schools, with small rural schools lacking specialized teaching and facilities and those losing brighter fifth grade students to secondary schools the most adversely affected.

The quality of small village schools is particularly contentious. They proliferated in the early 1990s, particularly as part of the backlash against the policies of concentrated settlement pursued under the communist regimes. Both the Hungarian and Polish case studies report that the results of rural schools are inferior to those of their urban counterparts, but the Hungarian case study argues that the relative performance of village school graduates can be related to their socioeconomic backgrounds rather than the quality of their schooling, and the Slovak case study suggests that their results are no worse than those of larger schools. The consensus seems to be that the smallness of village schools may be costly, but is not an education disadvantage in the first four grades, while the presence of a school considerably enhances a village's social cohesion and cultural identity.

Funding

The clearest benefits of devolution have been in the funding of school systems. Local governments have generally shown a strong sense of responsibility for their local schools and a willingness to contribute more than they are obliged to do. In countries where they share financial responsibility for part or all of the school system with the state, their contribution has more than compensated for relative declines in state funding. By contrast, the Slovak schools, which remain totally dependent on the state budget, show the strongest signs of financial shortages in terms of both operating debts and outstanding repairs.

Social and economic change in the last decade has resulted in difficulties in recruiting and retaining a skilled and motivated teaching force. Private enterprise offers better rewards for graduates in several disciplines most in demand by schools. The devolution of school management cannot make a major impact on market forces, but some evidence indicates that Czech, Hungarian, and Polish local governments have improved remuneration to retain or secure teachers in scarce disciplines or in cities, where competition is the greatest.

Opponents of devolution argue that it will produce inequity in the funding of school systems, because the

resources available to schools will vary with the wealth and tax base of the local governments responsible for them The country case studies provide little evidence to support this view Much of the additional contribution of larger towns has been offset by higher costs, both of physical plant and more specialized teachers Indeed, devolution may improve equity, in that state budget contributions, while remaining the dominant source of finance, are converted from historic cost to a normative formula. In Slovakia, the one system out of the four financed until July this year only by the state, some districts received as much as two-thirds more funding per student than others. Elsewhere, and now in Slovakia, the number of students is the dominant factor determining state funding, with some weighting for the higher costs in rural areas. The case studies agree, however, that the developments of the last decade have resulted in a growing differentiation in the quality of schools and the types of education and subsequent employment opportunities that they provide.

Differentiation

The report also noted differences in some, but not all, the countries in the measured performance of students from rural and urban primary schools. These can be attributed in part to differences in the more specialized teaching and equipment required in the upper primary grades. The Hungarian case study, however, draws on research that suggests that these differences can be attributed as much (if not more) to the socioeconomic backgrounds of students and the stimuli of the family environment It would not be surprising if a similar conclusion applied to the other three countries

The consequences of differentiation are more marked in the case of secondary schooling. Vocational schools have also varied in their responses to market change. The curricular range that they offer has an increasing impact on the careers and lifestyles of their graduates.

In all four countries parents may seek to place their children in schools outside the designated school district. Their chances of success depend on both the capacity of the school of their choice and the ability of their children to compete in admission tests. Family background and ability to meet transport costs count significantly

The link between social and educational differentiation is apparent and growing. Systems that base teaching staff levels, or even total funding, on numbers of students give the clearest encouragement to schools to maintain the relevance and quality of their education. They also provide the greatest opportunity to respond to changes in demand and the greatest spur to efficiency. However, schools grappling with the severest problems of social disadvantage need an exceptional degree of professional and financial help from state or local governments This type of positive discrimination is only beginning to develop

Inconclusive Results

The case studies suggest that states have been no more successful than local governments in rationalizing school systems and staffing, and if anything, slightly less efficient. Central governments are inhibited by the power of teachers' unions and local governments by the number of teachers elected to councils. Some evidence suggests that those Hungarian municipalities that had given schools the right to manage their budgets and had allocated funding to them on a normative, per student basis had made the most progress in rationalizing their school systems. Schools had been under direct pressure, both to attract students and to adjust staff numbers. In Poland, however, national legal restrictions on firing teachers, or even transferring them to other schools, severely constrain the use of per student funding to rationalize staffing levels and costs. Equally important to efficiency is the way in which individual schools use resources. There is a growing tendency to give schools legal status This generally gives them the discretion to make budgets, shuffle funds between expenditure items, and retain unspent balances at the end of a budget year.

The relationship between divisions of responsibility for schooling and its effectiveness is diverse and inconclusive. The four countries are still searching for the appropriate balance between national and local responsibilities in the education sector. After the initial surge of devolution, ministries of education have tended to emphasize the constitutional guarantees of education and the need for strong state supervision, if not direct funding and management of schools. They have all retained the power to negotiate and set terms of employment for teachers, regardless of the financial consequences for either state or local budgets.

The need for national governments to ensure some degree of equality in access to education and some degree of uniformity in content and in minimum standards can scarcely be denied. That some ministries of education have been slow in developing the capacity to fulfill this role is a separate issue. Nevertheless, the quality of local education is a major concern for parents and for local

communities. The evidence of the case studies is that local governments are as concerned as states about educational standards, if not more so. Local governments' financial contributions have considerably exceeded the levels expected of them by intergovernmental finance systems, and in some cases have compensated for the underperformance of state budget obligations. The country where schools have suffered the most from underfunding has been Slovakia, where local governments have had no legal responsibilities for education.

The case studies clearly show, however, that educational management is a tripartite game, with the individual school as a third and active player. School directors and teaching staffs have much operational freedom, and teachers collectively exercise strong influence on both local and national decisions. School boards and parents may also play a significant role.

Systems that fund individual schools largely on the basis of student numbers and allow them flexibility to manage their own staffing levels and remuneration promote both equity and efficiency; however, the effect of financial incentives should not be overstated. The ambition and morale of the teaching force are closely associated with the attraction of motivated students and a sense of relevance to contemporary society. Whatever the balance of responsibility between state and local government, the key factors in school governance are the discretion and accountability of the individual school.

Parental market choice is constrained, however, and Darwinian solutions ("Let's weed out the weak") are inadequate by themselves. In particular, schools serving disadvantaged localities or social groups need special support. The challenges to government, whether national or local, are to develop the capacity for normative supervision and to combine a high degree of delegation to school management with selective intervention and support.

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Reforms in Russian Primary and Secondary Education: Losses and Gains

By Natalia Bartasheva

Russia has introduced a number of reforms in elementary and secondary education, such as elaborating academic curricula, producing new textbooks, and using new teaching methods; however, it still has much to do if it is to use resources efficiently, provide teachers with decent salaries, and equip schools with computers and connect them to the Internet.

Private schools were founded in Russia following the enactment of new legislation in 1991 and 1992 that permitted the existence of nonstate educational institutions and specified the necessary licensing and accreditation procedures. Tuition-based educational services were also introduced at state schools, and home-based studies (intensive self-study without classroom instruction) were permitted. These new initiatives were accompanied by innovation in curricula, and students were allowed to select materials from a variety of educational literature. However, government bureaucrats, who wanted to preserve their positions and privileges, prevented more radical educational reforms. Thus regulations that would have granted more freedom to teachers never got off the ground.

Despite these stumbling blocks, the number of new nonstate schools has been growing each year, from 368 in 1993 to 607 by 1999. A variety of nonstate schools were established. This includes secondary schools specializing in certain subjects, such as economics, mathematics, humanities, or the arts; religious and ethnic schools; secondary schools for girls; military schools; university-based secondary schools; and foreign language schools. All these institutions charge tuition fees.

Because of their innovative approach to curricula and application of new teaching methods, such schools are in high demand, because many students plan to obtain higher education degrees abroad . Some private schools are offering the Test of English as a Foreign Language (TOEFL) exam and the Scholastic Aptitude Test or the First Cambridge Certificates, as these exams are mandatory for students wishing to continue their education in a foreign country. To obtain an international bachelors' degree, a secondary school graduate must continue

studies for an additional year and study six subjects in English, subsequently only those fluent in English and with a strong background in mathematics are eligible for the international bachelors' degree program.

Among the public, the belief that only state-licensed and state-accredited nonstate schools are reliable is widespread. Although state-licensed schools do have the right to teach children, only those with accreditation are entitled to issue the state certificates required for admission to national and foreign colleges and universities. Thus unlike what happened in other branches of the economy, the education sector emerged not through the privatization of state-owned schools and universities, but through the creation of new schools in addition to those owned by the state.

Russia has 68,000 secondary schools, two-third of which are located in villages. According to 1999 data, nonstate secondary schools made up less than 1 percent of all schools, and only 0.2 percent of all students attended those schools. Thus most children still attend state schools. Students may obtain proficiency and skills beyond federal and local standards, but only with additional funding from either their parents or other private sources.

A letter from the Ministry of Education dated July 21, 1995, outlined additional fee-based education services that state schools can offer. These include courses in special subjects not required by the national curriculum, such as additional foreign languages, vocational skills (driving or typing), sculpture, and gymnastics, with the added stipulation that these courses be taught outside school hours,

When education was standardized nationwide, from Kaliningrad to the Far East, all children used the same textbooks and studied the same curriculum. A great deal has been done recently to produce new textbooks, and teachers are now allowed to select and use any educational literature. The federal list of 700 textbooks was introduced to ensure the uniformity of the educational process nationwide. These textbooks were selected on the basis of public appraisal and are supposed to be made available to all students at no cost. However, students receive only a fraction of the required textbooks: 25 percent in 1997, 7 to 9 percent in 1998, 18 percent in 1999, and 57 percent in 2000.

Curricula are continuously changing. According to expert opinion, today's curricula are overloaded with natural sciences and should be more focused on humanities and social sciences. Curricula in chemistry, physics, and biology are to be reduced, and more attention will be given to foreign languages. The overall academic load has increased by 50 percent, which has affected children's health. Previously students in grades four through eight had 24 hours of class time per week, but now have 31 hours per week.

Education institutions cannot make use of new educational technologies unless they have sufficient numbers of computers in classrooms. Recent years have seen a good deal of improvement in this area. An initiative by the president provided Rub 1 billion to equip village schools with computers in 2001, and local authorities also contributed on a matching basis. Such programs are being implemented in Novosibirsk, Samara, Tomsk, Voronezh, and other regions; however, funding is still a huge constraint: currently only 20 to 25 percent of Russian schools have computers. Moreover, only 3 percent of schools can connect to the Internet. The government's strategic development program for 2001–10 envisages that by 2005 at least 60 percent of secondary schools will have computers in their classrooms and will be able to connect to the Internet. Students have also been promised individual access to computers for at least six hours per week.

Given limited financial resources, the financing of education is still at a crucial point. Budget expenditures on education fluctuated between 2 9 and 4.5 percent of GDP during 1991-98, and are expected to stand at 4.2 percent in 2005. Thus education is underfunded and, at the same time, available resources are not used efficiently. In most schools new curricula coexist with outdated materials and facilities. Despite financial guarantees from the government, teachers' salaries are often delayed. In 1985 the average salary of a school employee was only 77 percent of the national average and has declined since. This has resulted in a chronic shortage of teaching staff.

Despite these multiple obstacles, reforms are going ahead. With the introduction of a 12th year in secondary school, 10 years of schooling will be mandatory. After completion of the mandatory 10 years, around half of the students are expected to go on to vocational or other technical schools, and those who wish to go to colleges or universities will follow up their secondary education with another two years of study. Thanks to the increased length of schooling, Russian students will be less burdened with lessons and will be better able to compete for admission to higher education institutions

abroad. Extending education will help bring the Russian curriculum closer to that of European schools, for instance, Russian students currently do not have classes on probability theory and statistics, subjects taught in European secondary schools.

This year, on an experimental basis, a single state examination was introduced to serve both as a graduation and admissions exam. In most cases secondary school graduates are obligated to pass several exams required by the state, and depending on their interests, they may have to sit for an array of other examinations. Subject examinations are to be held on a national level, thereby enabling an objective assessment of students' knowledge and logical reasoning.

To sum up, while perceptible results have been attained in terms of content, in organizational and financial terms Russia still has much to do. A few positive reforms are under way, but the Russian education system is still badly in need of additional reforms to reach the final goal: giving all students the best chance to succeed.

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Private Education in the EU

By David Hayhurst

The very mention of private schools conjures up a variety of different images for people in various parts of Europe. In the United Kingdom the phrase "old school tie" is virtually synonymous with "old boy network": a well-entrenched, centuries-old tacit network of almost exclusively wealthy, and often titled, plutocrats in firm command of the upper echelons of business, politics, and society. Elsewhere in Western Europe private education also often has a certain stigma of elitism firmly attached to it.

In reality, there are widely different legal definitions within the EU as to what constitutes a private or autonomous educational institution. The most common definition regards any manner of formal education that is founded and wholly organized by nongovernmental agents or individuals as part of the private sector, but within this broad category, distinctions are almost always made between strictly private education that involves no state financial assistance whatsoever, and varying forms of grant-aided education that may be made available to teaching institutions.

In the first case, institutions are wholly financed by individual patrons or by nongovernmental associations under private law. In the second case, grant-aided schools receive public funds, but the amounts of such funds often differ widely, and in many instances such funds can only be legally used for specific types of expenditures. Depending on the country, both forms of private institutions may or may not be subject to some type of governmental oversight.

Eurydice, the EU's information network on education in Europe, first published a detailed account of the different private education systems within each EU member state in 1992, at the request of the European Commission. The European Parliament asked for an update in 1999. The more recent Eurydice report chose to focus exclusively on private education bodies that provided full-time and compulsory instruction. This excluded any forms of preprimary schools, postcompulsory instruction, or institutions dealing with special needs children.

According to the report, EU member states can be divided into the following three groups in terms of institution and state authority relationships:

- In Greece and the United Kingdom most types of private schools receive no public funding of any kind; however, national governments still exercise significant control over such institutions.
- In France, Italy, and Portugal different types of contractual relationships between the state and private education bodies are possible. Schools may receive more or less funding, depending on their willingness to accept certain state-dictated conditions with regard to syllabuses, staff recruitment, and so on.
- In Austria, Belgium, Denmark, Finland, Germany, Ireland, Luxembourg, the Netherlands, Spain, and Sweden all private teaching institutions receive some level of state aid. Private schools are permitted to operate under similar conditions to public schools.

Government Conditions

All EU states have legislative conditions intended to guarantee minimal acceptable standards for providing

education. Legal conditions tend to become more demanding for private schools to receive greater state recognition and greater parity with state schools and/or more state funding. The vast majority of EU member states demand that teachers in any type of formally recognized private school have earned academic qualifications relevant to their disciplines and the student levels they wish to teach.

Austria, Germany, Holland, and Luxembourg also have legal stipulations regarding teacher suitability that extend to the morality or fitness of character of potential instructors, particularly with regard to being able to prove themselves to be law-abiding citizens and generally sound role models for youth. (Denmark and Sweden are the only EU nations that leave teaching personnel standards entirely up to individual private schools.) Legal requirements relating to physical teaching conditions tend to center on building and equipment safety and public health issues. National governments also determine minimum enrollment numbers in six EU states. It is in the area of pedagogical content, however, that the vast majority of EU countries make the greatest number of specific demands.

In all EU nations, private schools' compliance with legal norms is subject to some level of official scrutiny. Overall responsibility for governmental oversight lies with the national ministry or department of education in Finland, France, Greece, Holland, Italy, Ireland, Luxembourg, Portugal, Sweden, and the United Kingdom. Such responsibilities are left to subnational or local government levels in Austria, Belgium, Germany, and Spain. In countries where the overall responsibility for such controls is a national-level responsibility, practical arrangements for school monitoring and supervision for both public and private institutions take the form of either a national inspectorate, as in Holland, Ireland, Portugal, and the United Kingdom, or of other entities operating at the national level in the case of Luxembourg. Comparable arrangements exist at subnational levels in Austria, Belgium, Germany, Greece, and Spain. In Holland the national inspectorate is semi-autonomous and enjoys self-governing status. This affords it a great deal of autonomy without affecting the overall responsibility of the Ministry of Education as the relevant oversight body.

Public Funding

Three general categories of state expenditures relate to private schools: teaching staff costs; operational costs; and capital-related costs, that is, those involving building purchase or rental and maintenance costs.

Public funding schemes differ greatly across the EU. In six states national governments pay staff salaries in full. The state also frequently finances or meets operational costs. In the area of capital-related expenditures, however, EU states tend to be more parsimonious. The Netherlands is the only EU member to provide grants that cover all expenses involved in building construction, purchase, rental, and maintenance. In Belgium, Finland, France, Germany, and Ireland such expenses are met in part. Elsewhere private institutions must deal directly with local authorities on such matters.

Private schools in some EU countries have great liberty to set their own curricula. The United Kingdom has no legal requirements whatsoever for private schools to follow public school teaching programs, but private schools must meet certain expectations to satisfy the national inspectorate. In most EU countries students' academic qualifications are either identical or almost equivalent in both the public and private spheres.

Interesting idiosyncrasies are evident within the various states. In Germany the Basic Law prohibits any form of state monopoly on compulsory education. Almost all private schools are members of associations that defend their interests to the regional governments, but institutionalized cooperation between such associations and relevant government authorities is absent. In Ireland most primary schools are publicly funded, but are privately owned by a religious denomination. Multidenominational schools—established, owned, and managed by parents—also receive state support.

Italy would appear to be the EU country where debates on private school status and funding have been the most fractious, involving social debates between religious and secular parties that have spanned decades. The Italian Parliament only managed to overcome the half-century-old blockage of affording equal legal status to private schools in 2000. Financing is now provided only indirectly in the form of scholarships and tax breaks to private and public school students alike, thereby adhering to the constitutional requirement forbidding private institutions from burdening the state. However, many regional governments had already taken advantage of a 1997 law delegating certain administrative functions regarding education to them to offer grants and school vouchers to parents of children attending private schools.

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LGB Articles Now Being Accepted

LGI is now accepting unsolicited articles for its forthcoming editions of the Local Government Brief (LGB). If you are interested in submitting an article, please adhere to the following guidelines.

Each LGB has a general theme. Articles must be research based, policy oriented, and directly related to the focus of each particular issue. Furthermore, articles will ideally focus on one or more countries in either Eastern Europe, the Balkans, the Caucuses, or the former Soviet republics; however, articles pertaining to the topic but dealing with countries outside this region or with a global focus will be considered. The following is a list of the next four upcoming issues, along with the final submission date for unsolicited articles:

- E-governance: October 20, 2002
- Public health and health care systems: December 20, 2002
- Migration: March 20, 2003
- Administrative remedies for abuses at the local level of governance: May 20, 2003.

Articles must be written in English and should be approximately 1,500 words long. The LGB is divided into two sections, namely:

- **The Feature section.** Articles intended for the Feature section aim to provide LGI partners and clients with background knowledge about emerging regional policy issues. The Feature should introduce the "hot issues" related to the topic being addressed in the particular issue. It should also highlight major policy issues and the stakeholders involved, as well as analyze the policy context from the point of view of democratic governance, public administration reform, and local governance. The Feature is written in journalistic style (like the *Economist*). It follows an analytic approach, contains interesting and accessible language, and, if necessary, headings and subheadings. Authors are welcome to include tables and/or figures.

- **The Policy Guidelines section.** Articles intended for the Policy Guidelines section should be written for an audience of policymakers, professionals, consultants, experts, and trainers in various fields of local governance (public service delivery, outsourcing, budgeting, finance, taxes, revenues, regional development, environment, and so on). This section aims to increase the understanding of basic terminology and processes of local governance and public administration in the region. The section is well structured, clearly written, and presents a comprehensive introduction/guide to the topic discussed (textbook style). Of course, policy recommendations are also a key element of this section. Authors are welcome to include tables and/or figures. Short case studies on good practice experiences and on policy evaluation relevant to the topic are also welcome.

The LGB is printed both in English (1,500 copies) and in Russian (1,200 copies) and is circulated primarily among government institutions, public administration schools, research institutes, and policy think tanks in Eastern Europe and the former Soviet republics. You can find additional information about the journal at http://lgi.osi.hu/publications/newsletter/index.html.

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Growth in Transition: What We Know, What We Don't Know, and What We Should Know

By Nauro F. Campos and Fabrizio Coricelli

This article surveys the macroeconomic issues that marked the transition from centrally planned to market economies in Central and Eastern Europe (CEE) and the former Soviet republics. We first establish a set of stylized facts of the transition so far. We then critically survey the theoretical literature on transition, discussing various explanations for the initial output fall, as well as medium-term issues, such as optimal speed of transition, disorganization, institutions, and sectoral reallocation, as sources of output dynamics. Finally we provide conclusions along with a succinct list of suggestions for future research. (The original paper from which this summary is drawn also reviews the empirical literature to assess how well it translates the theoretical models and explains the stylized facts.)

In the early 1990s, when the first signs that the socialist experiment was finally over appeared, surprise and optimism immediately followed. The surprise arose because of the speed with which communist regimes collapsed, culminating in the dissolution of the Soviet Union in 1991. The optimism arose because the removal of the overwhelming apparatus of political control over economic activity could only mean prosperity in the medium term. The countries of CEE and the former Soviet Union were well prepared for rapid takeoff: they were industrialized, they had reasonably educated and healthy labor forces, and their population growth was minimal. Technology was lagging, but with the free flow of information and Western assistance, that could be overcome. Moreover, the substantial technical progress in the defense sector could perhaps spill over into the economies, reinforcing optimistic predictions. Some countries, notably Poland, had to tackle macroeconomic imbalances first, but economists felt it was well equipped for this task. Prosperity was, finally, around the corner.

Some 10 years have passed, and the results are mixed at best. The defining stylized fact of the first 10 years of the transition from centrally planned to market economies is the massive output fall. Although the myriad data problems still prevent a full assessment of its magnitude, few doubt its occurrence. Reported output fell in every single country of the former Eastern bloc. Indeed, by 1999 real GDP had surpassed its 1989 level in just two of the 25 countries, and in the most severe cases the observed cumulative output fall was larger than 50 percent of 1989 GDP (EBRD 2000).

The objective of this article is to take stock of what happened during the first 10 years of the transition in the countries of CEE and the former Soviet Union and of the various theories and explanations that have been proposed. This is an ambitious but important task: arguably, the transition will join the Great Depression as one of the most important economic events of the last century. Like the Great Depression, it will be intensely studied for years to come, in part because it marks a fundamental break in the ways of organizing and going about economic life. The time is ripe for taking stock of what we have learned so that we can identify directions for future research more precisely.

We chose to frame the discussion that follows in terms of economic growth after 1989. The reason for concentrating on the post-1989 period is the radical structural break that is currently taking place in the transition economies as the long-run trend is shifting away markedly from that established under communism. Transition itself can be thought of as a change in underlying long-run trends. For present purposes this break is best seen in the drastic changes, still taking place, in the way savings are mobilized and investment is carried out, in the different ways labor is organized, in how prices are

set, and in the full access to Western civilian technology and management practices. We also note that when economists talk about economic growth, what we have in mind is growth of per capita income or of productivity over long periods of time, but in the literature on transition economies, growth is used in a more literal sense, that is, it refers to the short-run dynamics of GDP per capita or labor productivity.

Growth Performance

The underlying question is what are the basic facts that a theory of transition should try to explain? Based on the analysis presented in the complete working paper, we believe that the facts set out in the table should stand as a robust set even in the face of future revisions and refinements in the underlying data. The evidence is sufficient to argue that in the first 10 years output fell; the stock of physical capital shrank; labor moved; a rapid and intense reorientation of international trade toward the West took place; the structure of the economies changed; institutional structures collapsed rapidly followed by a vacuum in many countries; and large social costs were incurred, principally in terms of worsening income inequality and mortality and poverty rates.

These seven facts apply to the countries of CEE and the former Soviet Union and should not be seen as stylized facts of transition in general. Indeed, the experience in Asia has been quite different, and a review of developments in transition economies cannot afford to exclude some of the most rapidly growing countries. Economic performance in China and Vietnam during the 1990s was impressive, and contrasts markedly with the performance of the European transition economies.

A large body of research addresses these differences. Why have these Asian economies been so successful in conducting transition and the former Soviet bloc economies so unsuccessful? Initial conditions certainly play a role. China, and the Asian economies in transition in general, had a relatively large share of agriculture in employment and in GDP, had much lower per capita incomes, and were relatively less integrated with the Council for Mutual Economic Assiscance (CMEA). Institutions also account for an important difference. In addition, these countries did not embark on political and economic transition simultaneously.

Seven Stylized Facts of 10 Years of Transition

Stylized fact	*Comments*
Output fell	In stark contrast with China and Vietnam, where growth has been rapid and sustained, output fell in all the countries of the former Eastern bloc. The exact magnitude of the fall is a matter of controversy, partly because of the sizable informal sectors that quickly emerged.
Labor moved	While labor moved in all senses, geographical mobility has been extremely low. Nevertheless, large changes in labor market status, sectors, and occupations are apparent.
Trade reoriented	CMEA trade collapsed, and with few exceptions was rapidly redirected to industrial countries (the slow reorientation in BUR is led by Belarus and Ukraine, not Russia).
Economic structure changed	The share of value added by industry in GDP declined rapidly. In the case of Central and Eastern Europe and the Baltics, this was due almost exclusively to the increase of the service sector's share. In the case of the CIS, the reasons for the slower decline are much less clear-cut.
Institutions collapsed	The fall of communism created an enormous institutional vacuum. Although efforts to understand and measure it are just starting, its effects have been sizable and omnipresent.
Transition costs appeared	One of the surprises of the transition was the appearance of unexpected costs. The rise in unemployment and income inequality was expected. The rise in mortality rates and the decline in school enrollment rates were not expected.

Theoretical Literature

The theoretical literature on transition can be divided into two groups, one focusing on the initial fall in output and the other on medium-term issues. The short time span that covers the experience of transition from planned to market economies means that any analysis of economic growth cannot neglect the initial sharp, and largely unexpected, fall in output. Moreover, in some instances the initial collapse translated into a persistent depression. Following the output collapse, a lively debate started on its causes.

Several observers claimed that such a collapse could be simply explained as a Keynesian recession driven by a fall in consumer demand. Other observers argued that the fall in output could not be described as a simple Keynesian recession, as the timing and magnitude of the collapse suggested a different interpretation based on the concept of "trade implosion." The trade implosion phenomenon can be ascribed to the substitution of the old system of coordination of production and exchange with a system of decentralized decisions and free markets. The absence of fundamental market institutions implied that the old production and trade mechanisms could not be quickly replaced by new, well-functioning mechanisms. The trade implosion approach stresses the important effects of institutional factors in relation to output performance in economies in transition. The growth literature also points to the fundamental role of such institutional factors as institutions relating to financial markets.

Explaining the Initial Output Collapse

The sharp and unexpected fall in output is a puzzle for economic theory for two main reasons. First, the liberalization of prices, the dismantling of trade barriers, and the elimination of pervasive state intervention in economic activity should have resulted in large efficiency gains. Second, based on the experience of programs implemented in developing market economies, stabilization as such should not have caused a sharp fall in output. For instance, in Latin America and Israel stabilization programs relying on the exchange rate as an anchor to reduce inflation were not associated with significant output decline, at least in the initial phase of the programs. Moreover, in market economies the output performance of stabilization programs relying on the exchange rate as an anchor differed sharply from that of countries that used monetary aggregates as an anchor.

In the transition economies output fell irrespective of the type of stabilization program implemented. Therefore existing models used to analyze market economies cannot readily explain their experience. In particular, supply-side explanations are likely to be more relevant for the transition economies than simple Keynesian models. Two main contributions stand out in the literature on the initial output collapse: one underlines the role of credit markets, the other the role of the so-called phenomenon of disorganization.

Credit Market Imperfections

In planned economies the artificial structure of production and trade imposed by the system made credit markets, and to some extent money, irrelevant, at least in relation to the enterprise sector. Dismantling the planning system implied that production and trade were not only decentralized, but were carried out by means of monetary or credit arrangements. Developing credit markets requires time. The availability of cash for transactions by enterprises was constrained by official credit, given that firms lacked financial savings, which were illegal in most centrally planned economies. (Calvo and Coricelli 1992, 1993) single out the credit market as one of the fundamental institutions missing in the formerly centrally planned economies. The collapse of CMEA trade can also be seen as an example of trade implosion, related to the abandonment of an old mechanism of trade and netting out of payments without substitution with a private credit market.

The imposition of tight financial policies at the time of price liberalization probably caused a credit crunch for enterprises. The contraction of central bank credit resulted in a contraction in overall credit to the economy, as private credit markets could not develop overnight. Liquidity shortages can, in principle, explain a temporary fall in output. Over time, firms can accumulate monetary balances and converge to the optimal level of output that they would have reached in the presence of perfect credit markets. Accordingly, output should follow a U-shaped pattern. An implication of this view is that output decline should be accompanied by a decline in productivity. Moreover, real wages would drop as well, as enterprises attempt to generate liquidity to purchase inputs.

Disorganization

An alternative channel that shares some of the main elements of the foregoing view is disorganization (Blanchard and Kremer 1997), defined as the breakdown of economic relations of the old regime, which cannot

be replaced overnight by new ones. Blanchard and Kenner claim that disorganization was an important reason for output collapse, especially in the countries of the former Soviet Union.

The main concept underlying this view is specificity in economic relations between firms. The period of central planning was one of extreme specificity, as firms were locked into relationships with a small number of preassigned firms, and in many cases only one such firm. Firms did not need to accumulate any information about other firms, and in particular they lacked information about their customers' ability and willingness to pay. A high degree of specificity implies the presence of monopoly rents. Production chains link firms to several suppliers, depending on the degree of complexity of production. Higher complexity implies a larger number of inputs. Under a decentralized system prices are set through a bargaining process. Customer firms, generally state enterprises at the start of reforms, make an offer price to their suppliers. If such a price is below the reservation price of the supplier, the supplier does not provide inputs to the state firm and output falls.

Assuming strong complementarities in production, the lack of even one input implies an impossibility to produce. The reason for inefficient bargaining is that the reservation price is known only to the supplier. An implication of the model is that the larger the number of inputs, the higher the degree of complexity of production, and thus the larger the output fall. One would therefore expect the output fall to be more pronounced in highly industrialized economies, and this may help explain the different output performance in the highly industrialized countries of the former Soviet Union compared with that of mostly agrarian economies such as China. Another implication would be that output decline would be worse in countries that started reforms from a more rigid system of central planning. In countries in which firms had already experienced decentralized bargaining mechanisms, output decisions, and even price setting, the adverse effects of inefficient bargaining would be less acute.

Creative Destruction and Optimal Speed

As transition progresses and several countries of Central and Eastern Europe started to grow out of the initial collapse, a literature focusing on the medium-term perspective and on dynamic issues developed. Structural change and the reallocation of resources across sectors and firms are at the core of this literature.

A popular view of transition describes output dynamics along a path determined by the sectoral reallocation of resources. As resources move out of the old state firms into the private sector, productivity increases. If there are adjustment costs or other imperfections, such as search costs, aggregate output is likely to drop initially and increase afterwards, when the private sector has reached a sufficient size. Accordingly, output follows a U-shaped path. The initial contraction in output is reminiscent of the Schumpeterian phenomenon of "creative destruction." Inefficient firms are weeded out, leaving room for the expansion of new, more efficient firms. A clear signal of such a Schumpeterian process would be an increase in productivity accompanying the initial decline in output, in stark contrast with the implications of the models described earlier. At first sight, making the process of transition as rapid as possible by shortening the initial period of decline in output would appear to be optimal. However, if one takes possible adverse feedback effects, such as the fiscal costs of the initial fall in output or the congestion effects in the labor market caused by high unemployment, into account, the normative implications of the models are less obvious. For these reasons a literature on the optimal speed of transition emerged.

Institutions and Growth

In recent years the literature on growth has paid increasing attention to the effects of institutions on growth rates, viewing the transition economies as a unique laboratory. Indeed, central planning was an institutional arrangement that has proven to be highly inefficient

The notion of institutions is too vague to lead to a simple theoretical treatment. Although the theories are still sketchy, several channels that contribute to what is referred to as social infrastructure or social capital have been identified. Romer (2000) divides the studies on the determinants of social infrastructure into three groups. One focuses on incentives, and underlines dictators' preference for building and maintaining social infrastructure that is conducive to low average incomes. The second group concerns cultural factors and encompasses religion, ethnic diversity, family structure, and civic participation. The idea is that ethnic homogeneity and common religion and culture, in addition to civic participation, increase social cohesion and trust. The latter seems to be crucial for the development of efficient financial markets. The third group focuses on individuals' beliefs about the right policies and institutions. Individuals' different beliefs imply different choices of institutions by governments.

All three channels seem important for transition economies. Out of a common shift toward more democratic societies and more liberalized economies, countries in transition have displayed a wide range of institutional arrangements, and for all of them the process of institutional building has taken a long time. A general problem the transition economies have encountered has been their assumption of the existence of a blueprint for efficient institutions and their attempts to adopt it. The debate between gradualism and shock therapy is a case in point (Lipton and Sachs 1990; Fischer and Gelb 1991).

Furthermore, we should not underestimate the role of social safety nets as a fundamental factor in generating social cohesion and support for market reforms. An additional important aspect in the analysis of institutions is the upcoming accession to the EU by several CEE countries. Indeed, in this case institutional change is largely constrained to occur within the EU's blueprint. However, entry into the EU is seen as one of the main objectives for the populations of CEE, which probably believe that EU institutions represent the right institutions.

Conclusion

Transition is a simultaneous change in economic structures and institutions, and the final outcome depends crucially on the coherence between economic reform in terms of the liberalization of goods and factor markets, macroeconomic policies, and institutional development. The collapse of output in CEE, and especially in the former Soviet Union, indicated a lack of coherence in reform strategies. In general, paying more attention to a comparative analysis of China's experience could prove useful. Initial conditions and economic structure were sharply different in China, but reform strategies also differed. Therefore the comparison with China highlights one of the main lessons that we can draw from the first 10 years of transition, namely, that reform strategies cannot neglect the different institutional structures. Based on our review, the following suggestions for future research stand out:

- **Our list of stylized facts is based on currently available data.** These data are limited in terms of both completeness and accuracy. A fundamental direction for future research is to try to validate these facts. More work should be devoted to examining the limitations and inadequacies of the various time series needed to study growth in the early transition years. For instance, recalculations or revaluations of the capital stocks are needed, along with attempts to disentangle the roles of public and private investment. The available series on labor should also be improved. In particular, future research should go beyond the number of workers and years of schooling and try to provide a more economically meaningful picture of the contribution of labor, specifically, in terms of hours worked and effective use of skills. More reliable estimates of physical, human capital, and labor contributions to growth will improve our understanding of the sources of this process and the relative roles of various crucial factors.
- **Research should focus more on institutions, including the role and size of the government**. A clear specification of the channels through which institutions affect growth is needed. In this respect the role of institutions for the development of financial markets is a particularly relevant area for research. This extends beyond purely conceptual pursuits. Data on institutions based on objective criteria are also highly desirable. A last concern is the emphasis on inadequate cross-sectional data, which we deem to be mistaken. Transition is a dynamic process, a crucial aspect of which has been the dynamics of institutional reform. The empirical efforts that attempt to put forward cross-sectional time series data on institutions in transition are few, and are admittedly crude at this point. One crucial suggestion for future research is to change this situation.
- **Relevant measures of initial conditions should be provided**. Moreover, researchers should study how they relate to degrees of distortions across sectors, across countries, and over time.
- **More emphasis should be placed on a better understanding of the role of economic reforms and reform strategies in dictating the path of the transition process**. This should be pursued both conceptually and empirically. A number of theoretical models stress the role of reform strategies, yet the data for discriminating among these models are lacking. The few available indicators are unnecessarily subjective, and more often than not the needed documentation on their construction is not disclosed.
- **Many new challenges to the conceptual frameworks we use to study economic growth and development have arisen as a result of the transition experience**. One key example of these new challenges is the need to isolate the sources and effects of reallocation from accumulation and technological progress.

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Effects of Ownership and Financial Status on Corporate Environmental Performance

By Dietrich Earnhart and Lubomír Lízal

Recent economic analysis has estimated the effects of different ownership structures on standard measures of corporate financial performance, such as revenue and capital investment, in the transition economies of CEE. In contrast, this paper estimates the effects of different ownership structures on corporate environmental performance as measured by air pollutant emissions in the Czech Republic during 1993-98. It also examines the link between financial performance and environmental performance.

Like previous studies of ownership, our analysis focuses on the effects of privatization, that is, on a comparison of state ownership and private ownership. We test the generally accepted hypothesis that private ownership generates better environmentally-related corporate performance. This hypothesis is based on the expectation that private owners reduce costs more effectively. Emissions represent costs, because they generally indicate an inefficient use of inputs; generate emission charges (at least in the Czech Republic); prompt a greater need for costly end-of-pipe treatment when production management generates more residuals upstream in the production process; and induce regulatory authorities to impose potentially costly penalties, such as fines and requirements to modify production processes. As an alternative hypothesis, perhaps preferences for better environmental stewardship, independent of cost concerns, differ by ownership structure. In this case, the state may express a greater concern for the environment by reducing emissions more strongly than private owners.

In addition, we examine variation across different types of private ownership. In particular, we distinguish between concentrated ownership, for example, a strategic investor, and diffuse ownership, for instance, an investment fund, using three measures: (a) basic investor categories, (b) threshold level for reporting ownership shares, and (c) concentration based on the single largest shareholder. One might anticipate that more concentrated ownership permits owners to manage costs better, including environmentally-related costs, through better monitoring of managers. However, concentrated ownership may harm firm performance, for example, highly uncertain business conditions may require managerial initiative and incentives to acquire information, and concentrated ownership may thwart these efforts. Therefore the expected effect of ownership concentration remains an unresolved issue.

Other recent economic analyses explore the links between corporate financial and environmental performance in mature market economies, especially the United States. Our study explores the effect of financial performance on environmental performance in the transition economy of the Czech Republic. In particular, our study assesses whether successful financial performance begets or undermines good environmental performance. Successful financial performance may allow a firm to generate internal financial resources that it can use to improve its ability to reduce pollution. This generation of internal financial resources is probably more important in a transition economy such as the Czech Republic, where internal financing is especially important for investment, because Czech accounting standards and tax laws require firms to finance all investment with retained profits.

Our analysis shows that successful financial performance improves future environmental performance. Moreover, we find that increased state ownership actually improves environmental performance relative to all other investor types, even though the state has apparently retained ownership in industries that produce higher levels of pollution. Indeed, during the Czech privatization of the early 1990s, the state retained a significant portion of assets in so-called strategic firms, which included many large enterprises engaged in heavy industry, which generally emit above average pollution. Nevertheless, after controlling for firm-specific fixed effects, which capture industry-specific effects, we find that greater state ownership leads to better environmental performance.

In addition, concentrated ownership, as measured by the single largest shareholder, improves firms' environmental performance, consistent with the notion that concentrated power allows an owner to manage costs better, including environmentally-related costs. Finally, ownership structure does not directly affect environmental performance; it only indirectly affects environmental performance by influencing financial performance.

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A NONPARTISAN ECONOMIC AND SOCIAL POLICY RESEARCH ORGANIZATION

Transition Policy Network: A Regional Network of Independent Think Tanks

By Clare Romanik

What should a minister of finance do once leaving office? For Albania's ex-finance minister, Genc Ruli, the choice was relatively easy: together with another "ex," the former foreign trade minister, he established a think tank, the Institute for Contemporary Studies. The Tirana-based research institute is one of 10 independent think tanks that are loosely affiliated within the Transition Policy Network (TPN), founded in 1997 by the Urban Institute and the Metropolitan Research Institute, Budapest, and the Institute for Urban Economics. As periodic one-on-one collaboration grew into more steady and mutually beneficial relationships, the concept of a regional network of public policy think tanks became a realistic possibility. East-East collaboration has been notoriously lagging West-East teamwork in donor assistance projects, and the network has proved to be an unusual approach to rectifying this situation.

TPN members are experts on a wide range of important public policy issues, including public finance and administration, urban infrastructure, social protection, housing policy and finance, corporate governance, civil society, and anticorruption initiatives. They are adept at turning their policy expertise into policy change. For example, the Bulgarian Center for the Study of Democracy is playing a major role in implementing and monitoring an anticorruption awareness campaign initiated by civil organizations and state institutions, and senior staff of the Russian Institute for Urban Economics serve on the Commission on Separation of Powers between the Federal, Regional, and Municipal Government, which will make recommendations to Russian President Vladimir Putin. The diversity of experience and special interests creates many possibilities for sharing expertise throughout the network.

Think tanks in Eastern Europe are facing many challenges, operating in an environment where think tanks were previously unknown. Through the network they receive support and share experience only available from other think tanks. On the occasion of its 10-year anniversary, the Krakow Real Estate Institute recently organized a network conference on think tank development and management. The participants mostly agreed that once their credibility as independent policy experts has been established, they must be continually vigilant to maintain their relevance by addressing important and timely issues, be they related to economic convergence with the EU, to membership in the European Monetary Union, or to corporate governance and fiscal federalism.

Mentoring the next generation of experts is another challenge. The network's research grants are targeted to mid-level staff of these institutes to strengthen and expand their professional expertise. In addition, TPN helps them publish their research results.

When TPN members assist governments in other transition countries, it boosts their credibility and prestige at home. Slovakia's Institute of Housing (IH) has

Members of the Transition Policy Network

- Albania: Institute for Contemporary Studies
http://www.ics-al.org/
- Armenia: Center for Policy Analysis
http://www.aua.am/aua/research/#cpa
- Bulgaria: Center for the Study of Democracy
http://www.csd.bg/
- Hungary: Metropolitan Research Institute
http://www.mri.hu/
- Moldova: Institute for Development and Social Initiatives
http://www.iatp.md/viitorul/des02e.htm
- Poland: Krakow Real Estate Institute
http://www.kin.org.pl
- Romania: Center for Political Studies and Comparative Analysis
http://www.iatp.md/viitorul/
- Russia: Institute for Urban Economics
http://www.urbaneconomics.ru/eng/index.html
- Slovakia: Institute of Housing
http://www.instbyv.sk
- United States: Urban Institute
http://www. urban.org/

provided housing policy expertise in Armenia, Georgia, and the Kyrgyz Republic; staff from Hungary's Metropolitan Institute have worked in Albania, Georgia, and Russia on local government finance issues; and the Moscow-based Institute for Urban Economics offered its expertise on housing finance and social assistance in several Central Asian countries.

TPN members are also providing technical assistance to each other. Slovakia's Institute of Housing worked with the Urban Institute to establish the Union of Homeowners' Associations, a financially independent NGO (and currently the second largest NGO in Slovakia) with regional training centers and an advocacy mandate.

The network is open to new members. Candidates should be nominated by at least one existing member and their membership must be approved by all existing members. A new initiative is being explored to build a virtual community through a members only intranet site (in addition to the present external site: www.urban.org/tpn). The site would host user groups on specific research interests and deal with policy research techniques, such as surveys, mapping for geographical analysis, and microsimulation.

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Fiscal Situation of Baltic Municipalities

By Viktor Trasberg

During the last decade, the Baltic countries have reformed their public administration systems in response to the overcentralization of their Soviet past. The reforms seek to devolve certain expenditure functions and revenue collection to lower levels of government. Yet despite this restructuring, serious problems still exist.

Municipalities in all three Baltic countries have limited fiscal resources to fulfill their main functions, and thus remain highly dependent on the central authorities. Moreover, regional disparities in public good provision have increased. Even though most municipalities' activities have become more transparent and efficient, in many cases their administrative capacity is still insufficient.

Administrative Structure

During the euphoria of re-establishing new local administrative units in the early 1990s, Estonia and Latvia focused on restoring systems that had existed prior to World War II. The mixture of nostalgia and economic naïveté led to the re-establishment of numerous thinly populated, financially weak local municipalities. In

Administrative Division of Baltic Countries, 1999
(number)

Unit	*Estonia*	*Latvia*	*Lithuania*
Rural authorities	205	472	n.a.
Towns	42	80	60
Regional governments	15	26	10
Total	262	578	70

Source: Organisation for Economic Co-operation and Development country reports (2001).

Lithuania, local public administration reform has moved slowly, and the problem of how to transform Soviet-style administrative units into units that are genuinely representative of local interests persists.

Estonia and Latvia have many more municipalities than Lithuania (see the table); however, Lithuania plans to increase the number of municipalities in 2003. Most municipalities in Estonia and Latvia have relatively few people: some 85 percent of Estonian municipalities and 91 percent of Latvian municipalities have fewer than 5,000 inhabitants. In Lithuania, only 7 percent of communities have fewer than 10,000 inhabitants. Moreover, in Estonia and Latvia the population is concentrated around the capital cities, which creates huge revenue disparities between these areas and low-density rural municipalities.

Are Transfers the Answer?

The share of Baltic municipalities in consolidated budgets remains less than one-fourth. Subnational governments receive most of their revenues from income taxes, which are a shared tax in Estonia and Latvia and a solely local tax in Lithuania. Other local taxes, such as land and property taxes, are insignificant, mainly because of the low tax base. In Lithuania tax revenues account for 97 percent of total revenues, while in Estonia and Latvia tax revenues represent less than half of total revenues

Municipalities' nontax revenues consist of income from their economic activities, privatization transfers, fees, fines, and user charges. They account for less than a fifth of all revenues in Estonia and Latvia and only 2 percent in Lithuania. In Estonia and Latvia, local municipalities receive a substantial share of their income in the form of central government grants as specific or general (equalization) fiscal transfers. The largest proportion of specific grants in Estonia and Latvia covers transfers to support education. General grants-in-aid (27 percent of Estonian municipalities' total revenues) equalize revenues, but also increase political dependency on the central authorities.

In Lithuania, increased tax revenues since 1997 have cut the amount of annual grants from the central budget, and in 2001 no transfers were made from the central budget to local budgets. However, Lithuanian local governments have fewer functions than their Estonian and Latvian counterparts, and therefore need less money.

Motivation for Further Reforms

Territorial and local budget reforms in all three Baltic countries continue to result in improved administrative capacity. This is crucial for the EU accession process, because adequate administrative capacity on the part of municipalities is an important requirement for membership. In Estonia and Latvia, reforms have focused on consolidating small municipalities into larger units to secure a tax base and fiscal autonomy, as well as to maintain their functions with fewer central government grants. In Lithuania, the thrust of reforms is to optimize municipalities' size and functions and to limit central government influence.

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Politicians Draft Election Program

"Let's not mention mass transport and vegetable prices, none of us have ever ridden the metro or done any shopping at a grocery store"

From the Hungarian Daily *Népszabadság*

Dismal State of Russia's Heavy Machinery Industries

By Pertti Naulapää

The production of heavy machinery, especially tractors, was once the backbone of Soviet engineering. A study carried out during late 2001 to early 2002 found that the condition of Russia's heavy machinery industries was gloomy. The main markets for this machinery are still agriculture, forestry, and construction, and in all these sectors the level of technology in Russia is extremely low.

With the disintegration of the Soviet Union, Russia's agricultural and construction machinery industries collapsed. By 2000 the manufacture of tractors and grain combine harvesters had fallen to 7 to 10 percent of their 1990 level, and the production of other machinery for the agriculture and forestry sectors had also collapsed. Annual production has risen slightly in the past two years to 15,000 tractors and 6,000 harvesters, but U.S. authorities and Russian government experts estimate that Russia still needs at least 600,000 tractors and more than 400,000 combine harvesters. Only about 50 percent of Russia's tractor fleet of 700,000 is fully functional, and the fleet continues to decrease at a rate of about 10 percent per year. Each year more than 20 percent of the grain harvest is lost because of the poor condition of agricultural machinery.

The production of construction machinery has also fallen sharply. Compared with 1990, the production of excavators had collapsed to about 10 percent by 2000 and of bulldozers to 20 percent, although production has picked up slightly since that time. About 50 percent of construction equipment in service has reached or exceeded its useful economic life.

Imports of agricultural machinery expanded rapidly before the ruble fell in 1998. In 2000 Russia imported about 14,000 agricultural and industrial tractors, including about 6,000 from Belarus. Imports of combine harvesters amounted to about 500 units in 2000. As concerns construction machinery, about 20 percent of excavators, 30 percent of cranes, 33 percent of scrapers, and 13 percent of bulldozers were imported in 2000.

Russian made agricultural and construction machinery became competitive after the 1998 ruble devaluation. Given Russia's low labor and fuel costs and existing service infrastructure, Western manufacturers found it hard to penetrate the Russian market. Productivity requirements in the Russian agriculture and construction sectors remain low, and Russian machines are adequate to meet these low expectations. Nevertheless, as soon as competition intensifies, the need for imports of high-productivity Western equipment will also increase.

The study mentioned earlier used benchmarking technology to evaluate Russian manufacturers of agricultural and construction machinery based on nine groups of indicators. For example, the average technology rating of the Russian manufacturers was about 40 on a scale of 100, while Scandinavian benchmark companies had ratings of between 90 and 100. Russian production technology and production management are generally at the level of Scandinavian manufacturers in the early 1970s, and most products are still based on 1970s and 1980s designs.

Thus the need for investment in product development, production, and marketing is huge. In addition, the systems for production and distribution of spare parts do not function either, as dealer networks are still being created. According to some Russian government experts, merely preserving the current tractor fleet would cost about $1 billion per year, yet only a fraction of this sum has been invested in tractor production in recent years. According to the same experts, about $20 billion would be needed for machinery and other inputs to restore the Russian agricultural complex to its earlier levels.

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Role of Foreign Direct Investment in the Russian Banking Sector

By Ilkka Salonen

The role of banks, particularly of foreign banks, is still underdeveloped in Russia, largely because of its history of protection. As a result, the banking sector is a bottleneck to economic growth.

While the number of banks in Russia rose to more than 1,000 before a banking law was introduced in 1967, the track record for foreign direct investment in the banking sector remains modest. The first joint venture bank was founded in 1989, ending the state's monopoly in foreign currency operations, and the first fully foreign-owned bank subsidiary was set up in 1993. At the same time, numerous newly established private Russian banks sought government protection for their domestic and foreign currency operations. Despite various deficiencies in markets and the operating environment, by June 2002 Russia had still managed to attract 26 fully foreign-owned bank subsidiaries and another 11 banks with majority foreign ownership.

Emerging Banking Market

The emerging, cautious state of banking in Russia is reflected in foreign involvement that differs from the situation in most Central and Eastern European countries, as all major foreign-owned banks in Russia are greenfield operations and their position is substantially weaker. Of the 30 largest Russian banks, only 6 are foreign owned, and the share of the 10 largest foreign banks amounts to no more than 7 percent of the banking sector's total assets of about $100 billion. Foreign banks in Russia have notably differing business profiles than elsewhere in Central and Eastern Europe, reflecting the differences in parent banks' strategies regarding Russia. Some of the largest foreign banks have been active in collecting corporate deposits, and more recently household deposits, which account for 5 to 25 percent of their balance sheets. Assessing the state of the market via major assets is complicated by caution in relation to risk taking. For example, foreign banks' corporate loans and interbank loans may contain limited exposure to Russian risk.

Ongoing Issues

Distrust of banks remains a leading reason for the low level of deposits, although the large shadow economy also avoids banks. Various Russian banks have mistreated their depositors, and banks thus face an uphill struggle to restore public confidence. Moreover, the sheer size of the largest bank, Sberbank, may restrain competition. The evolution of transparency in Russian banks has yet to reach real disclosure, and there is still no formal pressure on banks to be open. Only some of Sberbank's shares are publicly quoted. Most large banks apply International Accounting Standards, but small banks do not. Moreover, the general introduction of International Accounting Standards, which is slated for 2004, needs to be coupled with other improvements in internal and external bank supervision. In 1998, for example, all large banks that failed had previously published sound figures based on International Accounting Standards. Banks' balance sheets are heavily weighted with short-term liabilities, as the number of potential investors with long-term interests in ruble assets is limited, which is also hampering investment financing. As concerns borrowers, transparency is naturally important, but in the current stage of lending, such basics as collecting collateral require significant improvement. Indeed, the preconditions for bank lending even extend to the reform of Russian courts.

Winds of Change

In such an environment, even the largest foreign banks could not make much headway, and caution prevails. Foreign bank subsidiaries remain unwilling to engage in substantial investment, and parent banks are wary about injecting equity to prop up their lending capacity. In the future, expansion of foreign banking services in Russia may be a combination of two directions. First, while there is currently no need for large foreign direct investment in the financial sector for financing large investments in Russia, if a bank wants to become a serious player in Russia's still relatively volatile market, it must have a local presence. Second, some leading international banks may also make major acquisitions of Russian banks in the next couple of years, mainly to gain local retail banking capacity.

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BOFIT Discussion Papers

John Bonin and Paul Wachtel, **Financial Sector Development in Transition Economies: Lessons from the First Decade,** DP no. 9/2002, 61 pp.

The first decade of transition witnessed rapid and tumultuous financial sector development. Although few transition economies have reached the point where institutions and markets fulfill all the functions of market-based financial intermediation, progress has been much more rapid than had been anticipated. In many countries, active market-oriented financial institutions function where a decade ago there was only a state planning mechanism. Initial experiences showed that bank privatization programs often failed to achieve independence from government control and from undesirable weak clients.

It is now widely accepted that participation by foreign strategic investors in banking is an effective way to advance this sector Capital market development is complicated by the need to strengthen institutional infrastructure and regulatory mechanisms, while at the same time avoiding interference in the markets Virtually all the transition countries' capital markets are still missing many components.

Christoph Fischer, **Real Currency Appreciation in Accession Countries: Balassa-Samuelson and Investment Demand,** DP no. 8/2002, 36 pp.

The Balassa-Samuelson effect [Balassa-Samuelson's 1960s analysis predicted that the real exchange rates of fast-growing countries will tend to rise over time, mainly because growth bids up the prices of nontraded goods, in other words, productivity improvement biased towards traded goods] is usually seen as the prime explanation of the continuous real appreciation of currencies of the Central and Eastern European transition countries against their Western counterparts. This study shows that productivity shocks work not only through a Balassa-type supply channel, but also through an investment demand channel.

Conference Diary

For the Record

EU Enlargement in a Changing World—Challenges for Development Cooperation in the 21st Century
September 19-21, 2002, Ljubljana, Slovenia

Topics: Transition studies and development studies—the role of Central and Eastern European social science; EU enlargement and European development policy for a changing world; the Stability Pact for Southeast Europe—model for other crisis regions?; clash of civilizations or intercultural dialogue?; challenges for EU Mediterranean policy; from transition to accession—perspectives for the new members; EU trade policy and the new WTO Round; beyond fortress Europe—bridges to the South; impact of enlargement on EU relations with the developing world; and from aid recipients to re-emerging donors—the role of accession countries in the EU system of official financial flows.

Information: Institute for Economic Research, Kardeljeva pl. 17, SI-1000 Ljubljana, Slovenia, tel.: 386-1-5303-810, fax.: 386-1-5303-874, e-mail: stanovnikp@ier.si or recnikm@ier.si.

Forthcoming

Showcasing Russia: The Reforming Elite—An Euromoney Conference
October 3, 2002, Metropolitan Club, New York, United States

Organized by Euromoney and sponsored by Renaissance Capital and Ernst & Young, the conference will provide an opportunity to hear in-depth from the corporate leadership driving Russia's entry into global capital markets and to debate key market and policy developments. Is the Russian investment environment really improving, and is the improvement sustainable? What is driving the restructuring of Russia's largest corporations? What do they need to do to approach international levels of competitiveness, and is this achievable? These and many more questions will be discussed. The presenters will be senior leaders of Russia's reform program and CEOs of those Russian companies with the scale and quality required by global investors. The speaker line-up includes Russia's Minister for Economic Development and Trade German Gref and top management of leading Russian companies, including RAO UES, Yukos, VimpelCom, and GMK Norilsk Nickel.

Information: Suzanne Freeman, Euromoney Conferences, Nestor House, Playhouse Yard, London EC4V 5EX, tel.: 4420-7779-8394, fax: 4420-7779-8396, email: sfreeman@euromoneyplc.com, URL: http://www.euromoneyconferences.com/.

Youth Cooperation Conference
October 3-6 2002, Bornholm, Denmark

This conference is being organized by the Danish Centre for International Cooperation and Mobility in Education and Training to bring together representatives of the EU member states, the candidate countries, and the CIS and create the basis for cooperation in the youth area. The participants will exchange experience about project management and discuss new projects.

Information: Benedikta von Eltz-Rübenach, Cirius, Fiolstraede 44, 1171 Copenhagen K, Denmark, email: ber@ciriusmail.dk, URL: http://www.ciriusonline.dk.

International Financial Crises: What Role for Government? Cato Institute 20th Annual Monetary Conference
October 17, 2002 , Waldorf Astoria, New York, United States

Leading experts discuss the following issues: Should the IMF act as an international bankruptcy court? Would global capital markets be better served by new contractual arrangements that rely on market discipline, not politics, to determine bankruptcy procedures in the case of sovereign doubt? What lessons can be learned from the Argentinean default? Which is more likely to bring about monetary stability, currency unification or competition? Will the new Basel capital standards improve risk assessment or simply add new regulations that limit socially beneficial innovation? Participants include Samuel Brittan, Steve H. Hanke, Anne O. Krueger, Allan H. Meltzer, and Jeffrey Sachs.

Information: Conference Department, Cato Institute, 1000 Massachusetts Avenue, N.W., Washington, D.C. 20001; email: monetary@cato.org.

Unofficial Activities in Transition Countries: 10 Years of Experience
October 18-19, 2002, Institute of Public Finance, Zagreb, Croatia

An international conference organized by the Institute of Public Finance, Zagreb, will analyze the size, scope, causes, consequences, and policy implications of unofficial (illegal, unrecorded, unreported, informal, underground, hidden, shadow, parallel) activities in transition countries during the past decade.

Information: Institute of Public Finance, Katanciceva 5, 10000 Zagreb, Croatia; tel.: 3851- 481-9363, fax: 3851-481-9365, email: kott@ijf.hr, URL: http://www.ijf.hr.

Conference on East-Central Europe Infrastructure and Investment—How Can Companies and Government Agencies Upgrade Transport, Water, Telecommunications, Power?
October 30-31, 2002, New York, United States

Sponsors include Hewlett-Packard, the World Bank, the United Nations, FitchRatings, the *International Herald Tribune*, the *Washington Times*, the British Consultants and Construction Bureau, and the International Private Water Association. The conference will include presentations from mayors of key European cities; CEOs of companies based overseas; and leading representatives of financial institutions, including the European Investment Bank, the European Bank for Reconstruction and Development, and the Hungarian Central Bank.

Information: tel.: 1-877-422-8382 (inside the United States) or 1-415-374-8235 (international dialing), e-mail: GordonF20@ATTbi.com, URL: http://www.acteva.com/go/Nyconference.

Exchange Rate Strategies during the EU Enlargement
November 27-30, 2002, Budapest, Hungary

The International Center for Economic Growth is hosting this event. The purpose of the conference is to present theoretical and empirical analyses on exchange rate policies and the choice of exchange rate regime in pre-accession economies during the EU enlargement. Eight keynote speakers will address four sessions, and the organizers expect around 35 additional papers for presentation.

Information: Ágnes Szigetvári, email: aszigetvari@axelero.hu, URL: http://www.icegec.org.

Economic Development and Reconstruction Policies in Southeast Europe: Regional Cooperation, Trade, and Foreign Investment
April 10-12, 2003, Dubrovnik, Croatia

Organized by the Inter-University Center, Dubrovnik, which is an independent international institution for advanced

studies and a forum for learning and scholarship, co-sponsored by some 200 member universities and institutions of higher learning around the world. The conference is the second in a series that will address the issue of economic development and reconstruction in Southeast Europe (the first, held in April 1992, focused on the role of small and medium enterprises). The conference is designed to bring together academics, policymakers, and practitioners interested in issues relating to economic development and reconstruction policies in Southeast Europe to present research results and policy evaluations (what works and why), and to participate in intensive debate and exchange of views.

Application deadline: November 15, 2002 (for abstracts).

Information: Maja Vehovec, tel.: 385-51-338-067, fax: 385-51-322-621, email: maja.vehovec@ri.tel.hr, URL: http://www.hr/iuc/docs/konfer/confer.html.

Enhancing the Capacities to Govern: Challenges Facing the CEE Countries—11th Annual Conference of the Regional Center of the United Nations Online Network in Public Administration and Finance

April 10-12, 2003, Bucharest, Romania

This conference will discuss the theory and practice of enhancing capacities in public administration. Papers are invited on the main conference theme or on the themes of the working groups.

Information: Viera Wallnerova, Project Manager, NISPAcee, Hanulova 5/B, 840 02 Bratislava 42, Slovak Republic; tel.: 421-2-6428-5558, tel./fax: 421-2-6428 5557, email: Wallnerova@nispa.sk.

Fifth International Conference on Enterprise in Transition

May 22- 24, 2003, Split, Croatia

Organized by the Faculty of Economics, University of Split. The conference will have two focus areas: institutions, investment, and integrations and new challenges for the enterprise in transition. Prospective authors are invited to submit a short abstract (up to 250 words) in English, including the author's name, affiliation, and contact details, by September 30, 2002. Detailed instructions for authors will be provided to all the authors whose abstracts are accepted for the conference. Papers should be received by January 31, 2003, in order to be included in the review process. Details on conference sessions and presentations, as well as on conference venue, will be sent along with the instructions to authors by October 31, 2002.

Information: Faculty of Economics, 31 Matice Hrvatske, 21000 Split, Croatia; tel.: 385-21-430-600 or 430-700, fax: 385-21-430-701, email: eitconf@efst.hr, URL: http://www.efst.hr/eitconf.

Public Relations—An Instrument for Transformation and Development of Higher Education in Central and Eastern Europe

May 23-25, 2003, University of Economics, Poznan, Poland

Organizers: Chair of economic journalism and public relations, Poznan University of Economics, Poznan, Poland; and the United Nations Educational, Scientific, and Cultural Organization–CEPES, Bucharest, Romania. The conference will bring together professionals and academics working in the areas of both higher education and public relations in the European transition economies. Participants will discuss current reforms and development issues as they pertain to higher education and how to forge good working relationships and create strong competition between public universities and newly established private universities. Proposals for papers, based on concluded or ongoing research, case studies, working papers, and/or review papers must focus, among other things, on:

- The image of institutions of higher education—selling a "product" or fulfilling a mission?
- Differences in the public relations strategies of private and state-owned schools of higher education.
- Fund raising, a new phenomenon. Do universities need lobbying?
- Differences in the visual identity of private and state-owned schools.
- Role of alumni associations as multipliers of a positive image.
- Role of ranking in creating positive images of a university.
- University newspapers and editing houses, their role in the school's public relations.

Deadlines for submission: abstracts by February 15, 2003, and complete papers by March 15, 2003.

Information: Jacek Trêbecki, Chairman of the Organizing Committee, e-mail: kpr@novci1.ae.poznan.pl.

New Books and Working Papers *(continued)*

Continued from page 32

established as part of a World Bank loan to Moldova. ARIA was structured to combine private sector entrepreneurship with a public function in managing restructuring and bankruptcy. *The authors may be contacted at dellerman@worldbank.org or vkreacic@worldbank.org.*

Liesbet Steer and Markus Taussig, **A Little Engine that Could...Domestic Private Companies and Vietnam's Pressing Need for Wage Employment**, WPS 2873, July 2002.

Vietnam's small private sector (its share in GDP and employment are 8 and 2 percent, respectively) contributed 15 percent to industrial growth between 1995 and 2000. In addition, 43 percent of export growth in both 1999 and 2000 originated from the private sector. Since the implementation of the Enterprise Law in 2000, a total of 35,440 private firms have registered, nearly two-thirds the total number of registered firms for the entire preceding decade. Preliminary evidence suggests that the increase in the number of genuinely active private companies has been between one-third and one-half of the new registrants. Private companies are significantly better off now than they were a couple of years ago, when regional economic recession and stagnating domestic policy reforms nearly halted development of the formal private sector. At the same time, the sector's small base means that its impressive rates of job creation still fall far short of matching the rapid growth of the overall work force. *The authors may be contacted at lsteer@netnam.vn or markus@fpt.vn.*

Mark Gradstein and Branko Milanovic, **Does Liberté =Egalité? A Survey of the Empirical Links between Democracy and Inequality with Some Evidence on the Transition Economies,** WPS 2875, August 2002, 38 pp.

The literature suggests that formal exclusion from the political process through restrictions on voting rights has caused a high degree of economic inequality, and that democratization in the form of voting rights expansion has typically increased redistribution, at least in the small sample of episodes studied. In a less pronounced way, recent evidence also indicates an inverse relationship between measures of democracy based on civil liberties and political rights and inequality. The transition experience of Eastern European countries, however, seems to some extent to go against these conclusions. This opens possible new vistas for research, namely, the need to incorporate the length of democratic experience and the role played by ideology and social values. *The authors may be contacted at grade@bgumail.bgu.ac.il or bmilanovic@worldbank.org.*

Branko Milanovic, **Can We Discern the Effect of Globalization on Income Distribution? Evidence from Household Budget Surveys,** WPS 2876, August 2002, 22 pp.

The effects of globalization on income distribution in rich and poor countries are a matter of controversy. While international trade theory in its most abstract formulation implies that increased trade and foreign investment should make income distribution more equal in poor countries and less equal in rich countries, finding these effects has proved elusive. The paper uses data from household budget surveys and looks at the impact of openness and foreign direct investment on the relative income shares of low and high deciles. At very low average income levels, the rich benefit from openness. As income rises to higher levels (comparable to the income level of Chile, Colombia, or the Czech Republic), the situation changes, and the relative incomes of the poor and the middle class rise compared with those of the rich. Thus openness seems to make income distribution worse before making it better, or to put it differently, the effect of openness on income distribution depends on the initial income level of a country. *The author may be contacted at bmilanovic@worldbank.org.*

Gregorio Impavido, **On the Governance of Public Pension Fund Management**, WPS 2878, August 2002, 36 pp.

This paper surveys the empirical literature on the relationship between the governance of public pension fund management and investment performance. Consensus is building on the following statements:

- The sole objective of public pension funds should be to provide affordable and sustainable retirement income.
- Governors should be independent from political power and fit and proper for their role.
- The law of fiduciary duty should define the responsibilities of governors.

- Governors should be made accountable for the fund's performance.
- Independent performance evaluations (investment, audit, actuarial, and other) should be conducted by external and independent entities on a regular basis.
- Outside experts should be used regularly to define and implement fund policies.
- Internal controls should be established to avoid conflicts of interest.

Research is clearly needed to identify what governance elements are relevant for, and specific to, public pension plans that are not relevant for private pension funds; what governance elements are linked with performance, especially in developing countries; and what good governance practices can be used to improve the performance of public pension fund management in developing countries and how these can be implemented. A network of public pension fund managers that would be responsible for developing guidelines is needed. The *author may be contacted at gimpavido@world bank.org.*

Martin Ravallion, **Externalities in Rural Development: Evidence for China,** WPS 2879, August 2002, 35 pp.

Soumya Alva, Edmundo Murrugarra, and Pierella Paci, **The Hidden Costs of Ethnic Conflict: Decomposing Trends in Educational Outcomes of Young Kosovars,** WPS 2880, August 2002, 31 pp.

Other World Bank Publications

World Development Report 2003: Sustainable Development in a Dynamic World: Transforming Institutions, Growth, and Quality of Life, Oxford University Press, September 2002, 272 pp

This year's *World Development Report* examines, the relationship between the competing policy objectives of reducing poverty, maintaining growth, improving social cohesion, and protecting the environment over a 50-year period It emphasizes that many good policies have been identified, but have not been implemented because of distributional issues and barriers to developing better institutions The report reviews institutional innovations that might help overcome these barriers and stresses that ensuring economic growth and improving management of the planet's ecosystem require a reduction in poverty and inequality at all levels: local, national, and international.

Alexander S Preker and David M. Dror, **Social Reinsurance: A New Approach to Sustainable Community Health Financing,** International Labor Organization and World Bank, September 2002, 540 pp.

The World Bank Annual Report 2002: Volume 1, Year in Review, September 2002, 176 pp.

Dimitri Vittas, Gerard Caprio, and Patrick Honohan, eds., **Financial Sector Policy for Developing Countries: A Reader**, Oxford University Press, August 2002, 272 pp.

The dramatic events of the late 1990s brought the issue of financial sector policy in developing countries to the forefront. Financial sector reform involves strengthening the prudential regulations and supervision of the financial system. A well-functioning financial sector is necessary to ensure market-driven allocation of investible resources. Drawing on the accumulated experience of its contributors, this book provides an understanding of the sector's structure and dynamics.

Aaditya Mattoo, Bernard M. Hoekman, and Philip English, eds., **Development, Trade, and the WTO: A Handbook,** June 2002, 672 pp.

This handbook offers guidance on the design of trade policy reform and surveys key disciplines and the functioning of the WTO. It also discusses those issues and options that confront developing countries in using international cooperation to improve domestic policy and obtain access to export markets Separate sections summarize what constitutes sound trade policy; major aspects of the WTO from a development perspective; policy issues in the area of merchandise trade and the liberalization of international transactions in services; protection of intellectual property rights and economic development; new regulatory subjects that are emerging on the agendas of trade talks; and enhanced participation by developing countries in the global trading system The book also includes two CD-ROMs: "A Dataset on Trade and Production, 1976-99" and "Applied Trade Policy for Developing Countries: Outline, Content, and Readings for a Short Course."

Alessandro Magnoli, **What Do You Mean? Conceptual Clarity in Social Policy,** Inter-American Development Bank, July 2002, 237 pp. (Available at the World Bank's Infoshop.)

According to Jacques van der Gaag, director of the Amsterdam Institute for International Development: "How to deliver social services in an efficient and equitable way is one of the core issues of today's international development agenda. Magnoli challenges policymakers to think hard about what they mean by 'efficient' and 'equitable.' Is there really a trade-off between the two? This is a must read for everyone who takes the Millennium Development Goals seriously."

Other Publications

Richard Rose, **A Bottom Up Evaluation of Enlargement Countries—New Europe Barometer 1,** Studies in Public Policy no. 364, University of Strathclyde, Glasgow, Scotland, 2002, 60 pp.
To order: Centre for the Study of Public Policy, University of Strathclyde, Livingstone Tower, Glasgow G1 1XH, Scotland, tel.: 44-141-548-3217, fax: 44-141-552-4711, URL: www.cspp.strath.ac.uk.

Judith Thornton and Charles E. Ziegler, editors, **Russia's Far East: A Region at Risk,** The National Bureau of Asian Research, Seattle, Washington, 2002, 498 pp.
To order: The National Bureau of Asian Research, 4518 University Way, N.E., Suite 300, Seattle, WA 98105, United States, tel.: 206-632-7370, fax: 206-632-7487, URL: http://www.nbr.org, email: nbr@nbr.org.

OECD, **Russian Federation**, Economic Surveys, vol. 2002/5, February, 207 pp.
To order: Organisation for Economic Co-operation and Development, 2 rue Andre-Pascal, 75775 Paris, France, Cedex 16, tel. 331-4524-8770, fax: 331-4524-9175, email: silvana.malle@oecd.org.

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M. Duani. **After the Revolution [the FIDESZ Story].** *NGO News* (Hungary) 21:20-21, summer 2002.

P. K. Mitra and M. Selowsky, **Lessons from a Decade of Transition in Eastern Europe and the Former Soviet Union,** *Finance and Development* (International Monetary Fund) 39(2): 48-51, June 2002**Poland: Financial Times Survey,** *Financial* Times (United Kingdom) (Suppl.): I-VI, June 17, 2002

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